S. HRG. 101-165

SIGNIFICANT PRICE INCREASES IN PETROLEUM PRODUCTS SINCE THE VALDEZ OILSPILL

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON THE

SIGNIFICANT PRICE INCREASES IN PETROLEUM PRODUCTS SINCE THE VALDEZ OILSPILL

APRIL 17, 1989

Printed for the use of the
Committee on Energy and Natural Resources

U.S. GOVERNMENT PRINTING OFFICE

20-718 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S311-56.

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SIGNIFICANT PRICE INCREASES IN PETROLEUM PRODUCTS SINCE THE VALDEZ OIL SPILL

MONDAY, APRIL 17, 1989

U.S. SENATE,
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:02 a.m. in room SD-366, Dirksen Senate Office Building, Hon. Howard M. Metzenbaum, presiding.

OPENING STATEMENT OF HON. HOWARD M. METZENBAUM, U.S. SENATOR FROM OHIO

Senator METZENBAUM. The hearing will come to order.

The *Exxon Valdez* ran aground in Prince William Sound three weeks ago. Every night on television, all of America is witness to the environmental devastation left in its wake.

While those tragic scenes are playing out thousands of miles away, the effects of the spill are hitting much closer to home, as close as your neighborhood gas station. Consumers are experiencing the greatest single retail price hike ever—larger than when the Shah of Iran was deposed, larger than during the Arab oil embargo.

In three short weeks, here is what they did to the American auto drivers: up 17 cents a gallon in Cleveland, Cincinnati, and other cities in Ohio; up 15 cents a gallon in Kentucky; in oil-rich Texas, up 10 cents; in Gulf Coast Mississippi, up 10 cents; 20 cents a gallon reported in Utah and Colorado; 30 cents a gallon and more reported in San Francisco and Los Angeles.

The New York spot market for unleaded gasoline shows a similar increase in prices, over a 21 percent jump just since the spill.

But here is the kicker. Take a look at the figures on that easel. The spot price of crude oil has gone up only two percent over the same time frame.

The day before the *Exxon Valdez* slammed into Bligh Reef, unleaded gasoline traded for $3.68 more per barrel than crude oil on the spot market. But as of this morning, the price difference per barrel between unleaded gas and crude oil was $8.41, a spread of three and a half dollars to a spread of $8.41.

Such a leap does not make sense. It is not logical, it is not understandable, and I am not sure but it may not be ethical as well. The

gasoline that is going up in price was refined two months before the spill occurred.

We have invited witnesses here today who will try to help us understand why gas prices have gone through the roof. We appreciate the witnesses we invited who showed up. The Exxon Corporation is represented here today, but I also invited Arco, Mobil, Chevron, Texaco, Shell, BP, and Amoco, and I regret their failure to appear.

Now, we also invited the President of the American Petroleum Institute. The American Petroleum Institute is the trade association for the oil industry. The oil companies paid the President of API $329,000 just a couple of years ago to represent them. I do not know what his salary is today, but I am certain it is in excess of that.

But he would not show today, and this Senator thinks that with a salary of nearly $1,000 a day you would think he could find the time to appear before a Congressional committee investigating why his industry has raised prices such a major amount, with such great dimensions.

We can all draw our own conclusions, but I suspect one of the reasons he is not here is because it is tough for the oil industry to come before Congress to justify the unjustifiable.

The price hike is important in and of itself. It has cost consumers over $600 million of higher prices in the three weeks since the spill. That is more than $30 million a day in higher prices at the gas pumps, and the fastest price increase in the history of the U.S. gas market.

I want to emphasize what I just said. The recent price increase, the one we are living through at the moment, is the fastest price increase ever, ever for gasoline prices in this country.

And why did it all come about? Because Exxon negligently dumped ten million gallons of crude oil into Prince William Sound. Many oil companies in the U.S. do not even use a drop of Alaskan crude, and yet they have taken advantage of this situation and the American people to rip off millions and millions of dollars from automobile owners, who have no other alternative.

They have raised their prices and contributed to an historic transfer of consumer cash to oil company coffers. Some companies had trouble, some trouble getting crude, but the supply shortfall is so small, it did not warrant the price hike.

The price hike is so large that, even with slightly less crude available, total oil industry revenue is up by hundreds of millions of dollars since the spill.

Exxon of course is a special case by itself, losing not only access to some crude, but incurring the costs of the cleanup. But they have announced that they are planning to deduct the costs from their taxes, which have been incurred by the spill.

That means that the taxpayers will be stuck with a major portion of the tab. For every dollar they spend, the taxpayer will pick up 34 cents.

Senator Reid has introduced legislation to prevent this deduction from being allowed. I will support him in that effort. It is not like Exxon needs the taxpayers' help. In 1988 they recorded profits of $5,260,000,000. It was one of their most profitable years ever.

In fact, it was a banner year for the industry. In 1988, Mobil's profits were up 55 percent over 1987; Amoco's up 52 percent; Chevron's up 41 percent; BP up 29 percent; Arco up 29 percent. And the list goes on and on.

So when Exxon comes to the taxpayers looking for help and the other companies raise their prices for their customers, we can only come to one conclusion. It is not a question of need. It is a question of greed.

The hike raises other questions about the nature of the oil industry. When the Port of Valdez was closed to tanker traffic, Exxon and BP suspended some of their deliveries, claiming force majeure, an act of God. The port was only closed for five days and now operations have resumed to near normal, but we have not seen prices come down and the companies are saying that they may not come down.

We all know the rule of economics: When supply goes down, prices go up. But the size and speed of this increase on gasoline refined and delivered long before the spill demonstrates two unavoidable conclusions about the oil industry.

One, they are more than willing to take advantage of any catastrophe that comes their way—war, revolution, or environmental disaster. Two, they are more than able to take advantage of catastrophes.

In a truly competitive market, there would have been some logistical disruption from the spill, but the crude supplies could have been made up from other sources. But in markets such as this one, companies are able to take advantage of the disruption by jacking up prices, and there will not be enough competition to keep prices at reasonable levels.

The most discouraging observation is that company after company raised their prices, one after the other, even those that do not buy Alaskan oil. This oligopolistic pricing leads us to think that in today's market they do not have to collude with each other about prices; they just have to play follow the leader.

I intend to follow the companies' pricing decisions carefully, and I trust the Administration would do so also. These are discouraging observations and troubling conclusions.

At this point I invite our witnesses to comment on them.

But before doing so, I am very pleased to see that the ranking Member of the overall Committee is with us today, Senator McClure. Do you have an opening statement?

STATEMENT OF HON. JAMES A. McCLURE, U.S. SENATOR FROM IDAHO

Senator McCLURE. Thank you very much. Yes, I have a brief one.

It is important that we hold this oversight hearing to find out the facts about the recent increase in petroleum product prices. Hopefully, today's hearing will help unravel these factors and help us in a better understanding of what occurred and why it occurred.

Right now there are too many allegations and too few facts. There are some who would assert that the Alaskan oil supply disruption caused by the March 24th tanker accident was the sole cause of subsequent price increases. But I am not one of those.

While the temporary interruption of deliveries of Alaskan oil to the lower 48 undoubtedly contributed to oil price increases nationwide, that was not the only factor at play. For example, we know that just prior to March 24 crude oil, gasoline, and heating oil prices had all been on the increase on the international market. According to DOE data, between January 1 and March 24 world crude oil prices increased by nearly four dollars a barrel or 9-1/2 cents per gallon.

But the issue before us is not just a matter of price. The Valdez accident illustrates vividly that the U.S. can be affected both economically and politically by a relatively minor fluctuation in oil supplies.

It also points out, at least in this Senator's mind, that the United States urgently needs to develop a comprehensive national energy policy. I would like to observe that, as unexpected as the recent increases in price have been, having the marketplace allocate supply provides far more effective and efficient operation than government controls.

During the 1970's we saw that Federal price and allocation regulations made shortages worse, not better. And I for one do not intend to return to those bad old days. President Reagan's 1981 elimination of Federal oil price controls allowed the forces of supply and demand to regulate the marketplace.

As a result, even with the recent increases, the price of gasoline today is still below the price it was prior to deregulation in January 1981. According to the Lundberg gasoline price survey, in December 1980 regular unleaded self-serve gasoline was $1.23 per gallon. On April 7, 1989, it was $1.01 per gallon, an 18 percent decline in nominal terms and a 41 percent decline adjusted for inflation.

While government intervention may be warranted to assist in the transition following a major shortage, the nation is clearly far better off without major Federal intervention in the marketplace than it is with such intervention.

I look forward to the testimony of the witnesses, who I am sure will shed more light on this matter.

I ask unanimous consent to enter into the hearing record a relevant article which appeared in the April 13, 1989, New York Times.

Senator METZENBAUM. Without objection, it will be included in the record.

[The article referred to follows:]

GASOLINE PRICES POST A SHARP RISE

(By Jonathan P. Hicks)

Retail gasoline prices have jumped sharply in the last two weeks, reaching their highest levels in more than three years. Prices at some service stations have gone up by 10 cents a gallon or more, or about 10 percent.

Analysts and industry experts mostly attribute the huge increases to two factors: higher crude oil prices and widespread anticipation that gasoline supplies will be squeezed by an increase in summer automobile travel. The oil spill in Prince William Sound in Alaska and fires at refineries on the West Coast have also affected supplies, directly and indirectly, the analysts say.

Several of the analysts predict that gasoline prices will stay high for the rest of spring and through the summer, with demand remaining high for at least six months.

The striking increases this month began in California, but motorists in almost every part of the nation are now being affected. Service station owners from New England to Southern California say they have been compelled by their own increased costs to pass them on to consumers. So far this year, however, the increases in retail prices have lagged behind the advance in wholesale prices.

At Willie's Mobil Service Station on West 145th Street in Manhattan, between Adam Clayton Powell Jr. Boulevard and Lenox Avenue, the price of premium unleaded gasoline rose by 7 cents a gallon last week, to $1.299.

"We had to raise prices because we had to pay more for the gasoline," said Willie Cross, the station's owner. "But people will come around because they have to drive anyway. There isn't much they can do but pay the price."

At Belmont ARCO in Portland, Ore., "prices have gone up almost every day for the last week," said Robert Peck, the owner of the service station. "Prices have gone up here something like 10 to 15 cents a gallon in the last two weeks. Our customers don't like it, but there is not a whole lot they, or we, can do about it."

In the last month, the average price of a gallon of gasoline jumped by 10.2 percent, to $1.1063, according to the Lundberg Survey, which checks prices at 12,000 gasoline stations throughout the country every two weeks.

Gasoline prices have increased by 13 percent since January, when the average price was 98.04 cents a gallon, according to the survey, which records the average price of all grades of gasoline at full- and self-service pumps, as well as the tax.

The latest survey period ended on April 7, but service station owners say prices have increased notably since then. They add that unleaded premium gasoline prices are as high as $1.30 a gallon in some regions. According to the Energy Department, today's prices are the highest since February 1986, when the average price per gallon was $1.119.

"TEND TO BLAME ME"

Service station owners say the increases have angered motorists.

"The people who come in here tend to blame me," said Kazem Zadeh, manager of Georgia Avenue Amoco in Washington. The station last week increased its price of premium unleaded gasoline by 6 cents a gallon, to $1.139.

"Seventy-five percent of all we sell is premium unleaded gas and they wonder why the price is as high as it is," Mr. Zadeh said. "But I just tell them to look around and see what the other gas stations have done. It's all the same."

At Pagano Mobil Service in Boston, the cost of unleaded premium rose by 7 cents a gallon, to $1.259, in the last two weeks. And at Vieux Carre Exxon in New Orleans, the price of unleaded premium went up by 5 cents a gallon, to $1.139, in the last week.

The analysts say the increases are merely delayed reactions to the steady rise in crude oil prices since the start of the year. West Texas Intermediate, the benchmark American crude, stood at $16 a barrel on Jan. 1 and has increased by nearly 20 percent since.

"For some time, retailers had not been passing along all of the wholesale costs to the customer at the pump," said Trilby Lundberg, who publishes the Lundberg Survey. "Although competition had inhibited many retailers raising prices, that has apparently passed."

The analysts agree that the huge spill from the tanker Exxon Valdez on March 24 has not had a broad effect on the supply of crude oil. But they point out that many oil companies placed restrictions on wholesalers, limiting the amount of sales because of what they called "unusual and excessive" purchases after the incident in Alaska.

"When that happened, futures, spot and pump prices went up sharply and they've stayed up," said Dillard P. Spriggs, the president of Petroleum Analysis Ltd., a New York-based oil industry consulting firm. "That has continued to be the case even though the pipeline is now moving normal quantity."

Mr. Spriggs said there was widespread expectation among people in the industry that gasoline consumption would climb above the levels of last summer, when American motorists used a total of 7.8 million barrels a day in June and 7.5 million barrels a day in July, the peak months. Those figures compare with 7.5 million barrels in June 1987 and 7.2 million barrels in June 1986.

"If demand turns out to be higher than last year, the supply-and-demand balance will be tighter," Mr. Spriggs said. "And that will likely mean higher prices."

Senator METZENBAUM. I am very pleased and honored that the Chairman of the overall Committee has joined us this morning, Senator Bennett Johnston.

STATEMENT OF HON. J. BENNETT JOHNSTON, U.S. SENATOR FROM LOUISIANA

The CHAIRMAN. Thank you very much, Mr. Chairman. I am here to learn.

There are a lot of lessons to be learned, I am sure, from the Alaskan oil spill. I think some of those, the facts on which we can learn some of those lessons, I hope will be elicited today, and I look forward to the testimony.

Senator METZENBAUM. Thank you very much. We are happy to have you with us.

Senator Murkowski was the first to arrive.

STATEMENT OF HON. FRANK H. MURKOWSKI, U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Thank you very much, Mr. Chairman.

I first of all compliment you on holding these hearings, because I think from the information garnered from our witnesses we can have a better understanding of just how this took place.

Of course, as you know, Mr. Chairman, Alaskans are indignant, they are bitter, they are hurt. The situation with regard to the energy industry, particularly the oil industry, is certainly not a healthy one. The credibility of the industry has been undermined by this spill.

The very fact that we have to depend on the industry for our mobility and we have this unhealthy situation with regard to the extent of the credibility gap that has taken place as a consequence of this accident I think represents a very significant and unhealthy situation that we are going to have to work hard cooperatively to address.

As you know, Alaskans were led to believe that there was an appropriate plan available to handle a spill of any consequence. Obviously, that was not the case. As our President has indicated, it is going to be necessary that we review all contingency plans, not just in Alaska, but in every port that is handling petroleum products, because of the potential risk.

It is probably clear that in no case could there be adequate containment capability for an accident of this magnitude.

I think it is also important to recognize, Mr. Chairman, to recognize that this has brought a realization of the vulnerability and dependence on the movement of oil by tanker and marine vessel, because in the United States we move approximately 50 percent of our oil by water, either on barges or vessels coming in—most of those vessels, I might add, are foreign vessels that bring that oil from foreign countries.

The Alaska scene is the only one where the movement is indeed on U.S. bottoms, and I think that highlights the fact that we are dependent, not just in the United States but in the world—about 60 percent of the oil that moves in the world moves by vessel—and

because it brings home also the significant importance of the trans-Alaska pipeline to our domestic production.

One can wonder what the price might have been had the pipeline been shut down for a month. You know, that particular vessel was carrying about 12½ percent of the total crude oil produced in the United States that particular day. The pipeline produces about 24 percent of the total crude oil that day.

So I think we have an examination, Mr. Chairman, of a dependence as well. I think as well we should recognize that there are many factors that we have to consider with regard to the price of crude oil.

We have seen a large portion of the 10 cent increase was tied to an eight dollar a barrel increase in crude oil prices over the last six months. That is just factual. That is illustrated also by a comment that the Chairman made and one that I think deserves a highlight, by the fact that once the Port of Valdez was open the price did not fall.

Now, one can read into that that the price increase was under way already and realism dictates that it was. We have seen a fire at one of the Chevron refineries in California, reducing their gasoline output by 25 percent. We have seen retail prices, as a reflection of the increase of the future demand, retail prices increase by the futures market.

There are a lot of considerations in here and I think that is the value of this hearing. So I would urge my colleagues as we go through this rather lengthy process to reflect on a number of considerations, including the significance of just how much the U.S. has become dependent on the Alaskan oil and the reaction associated with what happens if that pipeline is reduced in its capacity.

And again, Mr. Chairman, I would urge, since we have the Chairman of the Committee here, to reflect on the significance of the problem with the credibility of our oil industry as we reflect on our dependence on that industry today. It is a serious problem.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you very much, Mr. Murkowski.

Senator Tim Wirth, we are very happy to have you with us here this morning. Do you have an opening statement?

STATEMENT OF HON. TIMOTHY E. WIRTH, U.S. SENATOR FROM COLORADO

Senator WIRTH. Thank you very much, Mr. Chairman. I appreciate your having this hearing and all our witnesses being here.

At the risk of being repetitive, Mr. Chairman, let me just once again make the point that many of us have been making for a long time, and I hope others will now make it as well. And that is that it is absolutely imperative that we as a nation once again recommit ourselves to a balanced approach to energy.

If we continue to depend only on supply, if we continue to try to think we are going to drill ourselves out of this mess, we are not going to do so. We have got to emphasize once again the conservation alternatives and think more smartly about energy.

Unfortunately, all of these other approaches have been ignored. For the last eight years, we have seen a drastic attack on conserva-

tion measures and, in the most shameless way possible, the last Administration put pressure on to drop the miles per gallon standards rather than to increase them, just precisely the opposite approach that ought to be taken.

We ought to be not only holding on, as you pointed out, Mr. Chairman, holding onto the fuel economy standards, but increasing them as we approach other energy efficiency technologies as well.

I was pleased with Secretary Skinner's decision of this last week to hold the CAFE standards for this year. Let us increase them, Mr. Chairman, not let them decrease further.

The energy conservation budget has once again been savaged, as it has been for the last eight years. And if we are going to be serious about the future, it is clear that we are going to have to do a lot better job about saving energy and we are going to have to at the same time once again approach energy alternatives, alternatives to traditional fossil fuel use, whether that is more imaginative uses of natural gas or looking at other than fossil fuel energy sources.

We are extremely vulnerable, Mr. Chairman, as you know. We are extremely vulnerable in the United States, and if there is any silver lining to the *Exxon Valdez* disaster, perhaps it is going to wake people in the Administration and many people in the government and many people in the country, wake them up to the very, very great vulnerability that we have.

Not only is the country vulnerable, Mr. Chairman, but consumers are vulnerable as well. I went to the Exxon station that I have been trading with for a long, long time and asked them what had happened to their price of gasoline in Colorado.

Now, Colorado does not get any of its crude oil from—it does not get any of the product coming in from Alaska. Ours comes from Nebraska, Wyoming, Texas, and the Caribbean. None of the Alaska supply goes to Colorado, according to the Exxon station on Southampton.

But we can see the price of energy has gone up 15 cents in the last ten days—a penny, three cents, three cents, one cent, one cent, three cents, three cents. This is just an inexorable increase in energy prices, right at a station that is not receiving any oil from Alaska.

Now, I am sure that there is a good explanation for this and our witnesses are going to be here to tell us what is going on. But I suspect, Mr. Chairman, that there is some significant gouging of consumers going on here, just as the country has been gouged by a very short-term and myopic energy policy.

To review all of this, we are here today, and I appreciate your holding this hearing. Thank you very much, Mr. Chairman.

Senator METZENBAUM. We appreciate having you with us, Senator Wirth.

Senator Burns.

STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Senator BURNS. Thank you, Mr. Chairman. And I too want to echo our thanks for having these hearings, and I have no formal statement as such.

I will make just an observation. There is risk in everything that we do in our life, whether it is moving our crude oil or whether it is just getting up and walking to work every morning or driving to work, whichever the case might be.

So there is always risk and risk of accidents and stuff like that that are in our daily life. I really have to fight the feeling that in a case like this, that the American people are not a little bit taken advantage of when this comes up in the marketplace at the end user's rate. And that feeling, I will have to say, is a lot stronger whenever I fill up my gas tank. I have to fight that back just a little bit.

And I agree with Senator Wirth that we do have to balance our energy policy. But so far government programs and the philosophy in government has not made that happen, and I do not think it can make that happen, until alternative energy forms are made economically competitive, in other words whenever those alternative forms can make a living and survive on their own. Government cannot make them survive and build in a profit incentive.

So we have a big area here to look at, and I will be happy to listen to some questions, listen to the answers very closely, and would have some later on.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Senator Burns.

Senator Conrad, we are happy to have you with us here this morning.

STATEMENT OF HON. KENT CONRAD, U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. I too want to thank you for holding this hearing.

I find a real anger in my state at the rapid run-up in prices. I found it interesting that the Lundberg Report has indicated this is the fastest and the greatest increase in wholesale prices in the history of the U.S. gasoline market.

People have called me and said, is somebody gouging? I do not know the answer. I hope we are able to learn that today.

But I think we can conclude that this points once again to the vulnerability of our lacking an overall energy policy, and it points to the need once again for us to focus on developing a strategy and a policy that will prevent us from being vulnerable in the future.

So again, Mr. Chairman, I want to thank you for holding these hearings, and hopefully we can get answers to these questions.

Senator METZENBAUM. Thank you very much, Senator Conrad.

I note that the ranking member of the Subcommittee has joined us. We are very happy to have Senator Nickles with us. Happy to hear from you, sir.

STATEMENT OF HON. DON NICKLES, U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Senator Metzenbaum, thank you very much.

From the publicity that we have in attendance today and the number of people, evidently there is a lot of interest in this, and I hope that we will speak primarily to the facts. There have been some increases, large increases, in gasoline prices, in retail prices.

I should also, I guess, be one to tell our colleagues there has been a sharp increase in prices that producers receive. And I will say, from one who is from a producing state, I am pleased that we have had a return to, I would say, more reasonable prices.

We are looking at posted prices—posted prices, for those who do not follow the oil markets closely, that is what producers receive. I think a lot of times the media speculates and follows the option market, and that is not necessarily what producers are receiving. It is much more volatile, much more speculative.

But posted prices have increased to $19.75, which is not high by—well, it depends what period of time. But if you go back to last November, it was $13.25 in my state. So if you look between November to now in April, you went from $13.25 to $19.75.

That is a very rapid rise. Of course, I would be one to say that $13.25 was too low. But certainly if you look at the differences between $13.25 and $19.75, you are looking at $6.50. You are looking at almost a 50 percent increase in a period of six months.

So I mention that to my colleagues so they will be aware, yes, there has been a very rapid rise in the last few months on the price for crude, which certainly makes a difference on the price of gasoline.

There has been high increases in the price of gasoline just in the last couple of months. How much of that is directly attributable to the Valdez accident remains to be seen. I for one would like to know, and I hope maybe we will learn that from this hearing.

So again, Mr. Chairman, it is a pleasure to participate with you this morning.

Senator METZENBAUM. Thank you very much, Senator Nickles. We are very happy to have you.

We have some members of the Senate who are not members of the Committee, and we are very happy to have them. They are very distinguished and well regarded. Senator Alan Cranston from the State of California, we are happy to hear from you.

We have a rule to ask our witnesses to limit themselves to five minutes. With respect to Senators, we allow a little bit of leeway, but not too much. No filibusters.

STATEMENT OF HON. ALAN CRANSTON, U.S. SENATOR FROM CALIFORNIA

Senator CRANSTON. I do not expect to take any leeway, and I appreciate the opportunity, Mr. Chairman, very much to testify before you and the many members of the Committee who are present.

I commend you for having this hearing today so we can take a closer look at what is going on around the country in terms of the

sudden and drastic gasoline price hikes that are occurring, allegedly as a result of the Alaska oil spill.

The oil spill was an environmental calamity of disastrous proportions, and certainly a lot of attention has been focused, as it should be, on the handling of the cleanup. But we also need to focus attention on what is happening at the gas pump since the oil spill occurred and take a close look at what it is happening.

According to some experts in the field, the period since the oil spill represents the fastest as well as the largest wholesale oil price hike in the history of the United States oil market, and that is what you said, Mr. Chairman, in your remarks this morning.

The tremendous price increases going on in my State of California have been largely attributed by the industry to the disruption of oil shipments as a result of the spill in Alaska. Regular unleaded retail gasoline prices have reportedly risen 18 cents in Los Angeles, 16 cents in San Francisco, and for no obvious reason.

It is bad enough that the environment and wildlife have been victimized. California drivers and drivers throughout the nation should not be added to the list of innocent victims.

The impact is felt nationwide. According to a recent report released by AAA, the cost of self-serve regular unleaded gasoline has increased about 12 cents since March 24th.

In Kentucky the price is up 15 cents a gallon, the same in Iowa. Nebraska's prices are up more than 13 cents; Mississippi and Texas, up more than 10 cents.

It is difficult to comprehend how the loss of one tanker, which equaled the loss of 250,000 barrels of crude, and the temporary shutdown of the Port of Valdez, which lasted a total of four days, has caused these increases. According to the Department of Energy, the crude oil shortage on the West Coast as a result of Valdez was negligible, amounting to no more than 12½ million barrels of crude, or the equivalent of 17 hours of U.S. consumption.

A 12 million barrel loss to the domestic market cannot realistically account for the recent price escalations, nor can the simultaneous occurrence of the historic summer driving period, often touted as another reason for the increase.

It cannot account for the increase when you look at the fact that the summer driving season, which begins April 1 and extends through October 1, is only just beginning. In California last year, the total increase in gasoline prices attributable to the driving season was exactly 3 cents.

The California State Automobile Association reports that it has not seen such a sudden and dramatic escalation of prices since the oil embargo of 1973. According to their recent survey, gasoline retailers have received increases of up to about 33 cents a gallon from individual wholesalers and about 11 cents a gallon from major brand wholesales since March.

Regular unleaded gas at self-service stations averaged $1.37, an increase of 8½ cents over the same period. The average of regular leaded at self-service stations is $1.05 a gallon, which represents an increase of 14½ cents, and full service is $1.32, up 10 cents.

I do not accept the claim, Mr. Chairman, that the Alaskan oil spill justifies recent gasoline price increases. The spill represented

a loss of only 12 million barrels of oil to the domestic market, an amount the Department of Energy states is negligible.

Crude oil prices on the West Coast went up only 3 to 4 cents a gallon. We have not seen a corresponding decrease in gasoline prices now that the port has been reopened and tanker traffic resumed. Why not if, as the industry asserts, the spill was the cause?

The numbers just do not add up. If there is an explanation or justification for the price hikes, it is not the oil spill and it is not a shortage of crude oil. I will be interested, Mr. Chairman, in what explanations this hearing draws from the industry.

The price increase not only harms drivers; it can harm the entire country, since inflation is a major fear that we have about the future of our economy and costs to the government and to all of us of that, and this kind of a spurt can lead to an escalation of general inflation that can be very harmful to the country.

I think it is necessary and appropriate that we take a close look at the situation to make sure that no one is taking advantage of the Alaska oil spill disaster and using it as a cover for price-gouging.

I heartily commend you, Mr. Chairman, for scheduling this hearing in such a timely fashion. I thank you, and I quit in four minutes.

Senator METZENBAUM. Thank you very much, Senator Cranston.

I think the oil industry and the American people might take note of the fact that normally hearings do not bring forth ten percent of the total Senate body to participate in a hearing of a subcommittee. But I think there is such major interest and concern about what has transpired in connection with gasoline prices that there has been an outpouring, and I am pleased to say that it has been on both sides of the aisle, indicating a sense of concern.

Senator Bryan, we are very happy to have you with us this morning.

STATEMENT OF HON. RICHARD H. BRYAN, U.S. SENATOR FROM NEVADA

Senator BRYAN. Thank you very much, Mr. Chairman.

I would like to add my voice as well to compliment you for holding these timely hearings, and I know that you will ascertain the underlying facts beyond this rather extraordinary price increase.

It has been noted that the events of the 24th of March of this year were an environmental disaster of the first magnitude. And just as you have reported in your own state and Senator Cranston and others have commented on the situation in their states, we in Nevada have experienced the greatest and quickest price increases in the history of American petroleum marketing.

In the southern Nevada area, the metropolitan Las Vegas area, price increases have ranged from 13 to 15 cents a gallon at the wholesale level. In northern Nevada, in the Reno metropolitan area, price increases are recorded in the magnitude of 17 cents a gallon at the wholesale level. In rural Nevada there have been reports of even larger increases.

The American Automobile Association, parenthetically, observed that Cincinnati in your home state, Mr. Chairman, has experienced

the largest increases that have been reported according to national surveys.

In my view, these increases are without justification and amount to gouging the American consumer. Tragic as the environmental disaster at Valdez was, to profit from an environmental disaster seems to me to be even more culpable.

Last week I took the occasion to write to each of the major oil producers and expressed my sense of outrage and urged them to roll back the price increases to pre-Valdez levels. Also last week, I offered on the Senate floor a resolution expressing the sense of the Congress and urging the oil companies to roll back their price increases to pre-Valdez level.

I was particularly pleased to note the comments, Mr. Chairman, of your colleague who serves on the Subcommittee, Senator Wirth, in mentioning the importance of the CAFE standards and alternatives that we must use to address the oil situation and the energy situation overall in the country.

I might add that my Subcommittee, the Consumer Subcommittee of the Commerce Committee, will be holding hearings on CAFE standards on the 2nd of May, and that our Committee will likewise continue to monitor the implications of the price increases which we are experiencing to the American consumer.

I noted, Mr. Chairman, that some comment was made to circumstances in the market that are external to the Valdez disaster, and I think that that is reflected. But I just note, from January 3rd of this year until March 24th, the date of the spill, certainly the oil companies took advantage of whatever circumstances existed in the international market to post some rather substantial increases.

One company in the Reno area in that time frame, January 13th to March 24th—that is before the spill—increased their prices at the wholesale level 11 cents a gallon. Other oil companies posted similar prices, one in particular 16 cents a gallon, another one seven cents a gallon, another one 22 cents a gallon.

So clearly whatever market forces might have been in operation prior to March 24th are more than adequately reflected.

In my own view the increases that have been posted since March 24th, as I have indicated, clearly represent a gouging of the American motorist, and I am hopeful that your Committee will bring those before the Committee to offer an explanation as to why this occurred.

I might just add parenthetically, I am particularly disappointed that a number of the witnesses that you invited to appear failed to appear, and I think that perhaps certain inferences might attach by reason of their failure to appear.

Thank you very much, Mr. Chairman.

[The prepared statement of Senator Bryan follows:]

Statement by Senator Richard Bryan

Before the Senate Energy and Natural Resources
Subcommittee on Energy Regulation and Conservation

On The Effect of the Exxon Valdez Oil Spill
On Gasoline Prices

April 17, 1989

Mr. Chairman. A cruel hoax is being played on the American consumer. As you know, gasoline prices have increased dramatically throughout the country since the Exxon Valdez oil spill on March 24, 1989. While the cleanup in Alaska is moving all too slowly, the major oil companies have been all too quick in cleaning up at the gasoline pumps.

My State of Nevada has been one of the states particularly hard hit by these increases. According to the Nevada Retail Gasoline Association, wholesale prices have increased as much as 12-15 cents per gallon since the tragic spill off the coast of Alaska three weeks ago. (I am supplying with my testimony today wholesale gasoline price information provided by the Nevada Gasoline Association and articles from Nevada newspapers showing the effect of these increases on Nevada consumers.) I am sure my colleague from California, Senator Cranston, will testify to similar increases in his State, and I understand that your State of Ohio has been another state adversely affected.

These price increases cannot -- and should not -- be justified by the temporary disruption of shipping of oil from

Alaska. According to one analyst who surveys over 17,000 stations nationwide, this increase was the "quickest as well as the greatest wholesale price hike in the history of the U.S. gasoline market." [Trilby Lundberg, publisher of the Lundberg reports.] Indeed, any impact on the market resulting from the Exxon Valdez accident should be only temporary and limited in nature. In fact, shipping has now been resumed.

These dramatic price increases appear to be nothing less than a blatant attempt to gouge American consumers. But why should American consumers have to pay? This tragic accident was the result of the negligence of one of America's largest corporations. Exxon did not see fit to have even one member of the crew on the bridge who was licensed to command the vessel: a vessel measuring almost 1000 feet -- more than three football fields -- and carrying over 50 million gallons of crude oil.

An Exxon executive was recently quoted as saying that consumers should pay for the clean up because it is "just like any other normal expense of doing business." [AP wire story, 4/10/89] Mr. Chairman, I do not accept that negligence is a normal part of doing business -- and I certainly do not believe that American consumers should have to pay for that negligence.

An oil spill caused by an oil company's own neglect should be paid for by that oil company -- or the oil company consortium

on the North Sea -- not by American consumers.

Mr. Chairman, I commend you for holding these hearings today because I would like to hear from the oil companies -- and from others -- a straightforward explanation for the dramatic increases in gasoline prices. Ten days ago, I wrote oil company executives imploring them to roll back what I believe are unjustified increases. Last week, I made a statement on the floor of the United States Senate, and introduced a Sense of the Senate resolution to the same effect.

However, Mr. Chairman, you and I both know that the oil companies are not voluntarily going to charge less for a product if they think they can get away with it. Indeed gasoline price are continuing to increase, notwithstanding the fact that shipping has resumed. I have had reports from Nevada that there have been some wholesale prices increases as much as 6 cents/gallon in the past week alone.

I urge you and all of my colleagues to send a clear signal to the major oil companies of this country that we will not allow American consumers to pay for their negligent mistakes. Congress must continue to look into this matter and, if appropriate, consider suitable legislative remedies.

If these price increases do not stop, I also intend to hold

hearings in the Commerce Consumer Subcommittee to review the affect of these increases on American consumers.

Mr. Chairman, I have appreciated the opportunity to testify and look forward to working with you closely on this issue.

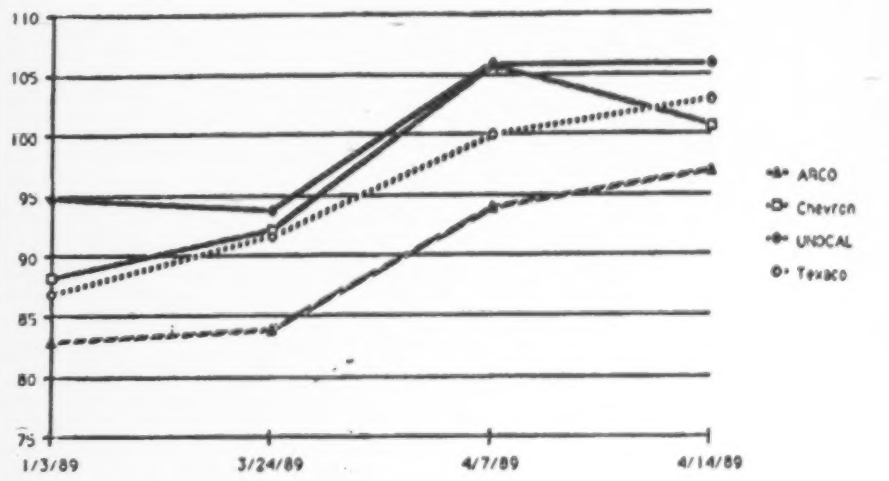
Charts A& B Raw Data

Unleaded	Las Vegas			
	1/3/89	3/24/89	4/7/89	4/14/89
ARCO	82.9	83.9	93.9	96.9
Chevron	88.2	92.2	105.7	100.7
UNOCAL	94.8	93.8	105.8	105.8
Texaco	86.8	91.7	99.9	102.8

	Reno			
	1/13/89	3/24/89	4/7/89	4/14/89
ARCO	70.9	81.9	95.9	98.9
Chevron	75.9	97.9	108.9	106.9
UNOCAL	89.1	96.1	109.1	114.1
Texaco	81.9	97.5	110	116.2

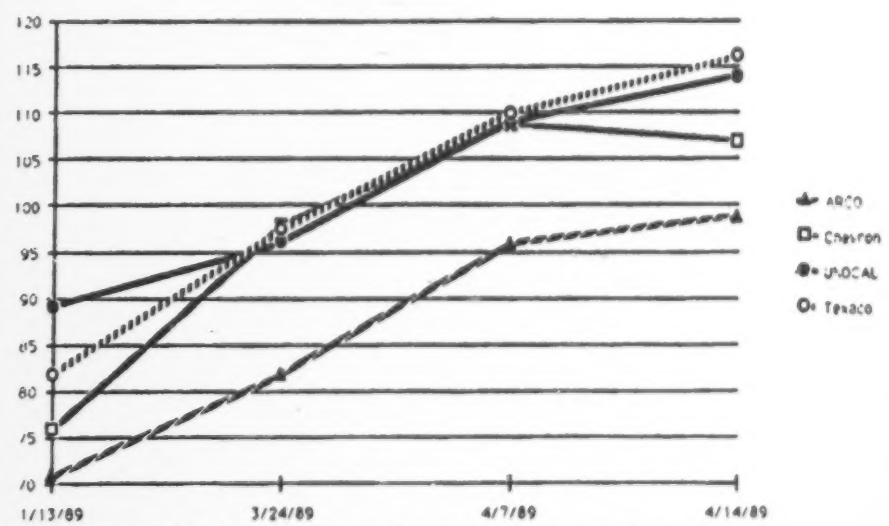
Dealers Buying Price
Las Vegas

Unleaded Gasoline



Dealer's Buying Price
Reno, Nevada

Unleaded Gasoline



Source: Lundberg, Opis, Dealer Surveys. Prepared By the Nevada Gasoline Retailers

RAW DATA Charts C&D
(Relationships between Crude Price, Marketing & Refining Profits, Retailers Profit)
Call of the Chart: WHO is getting These HUGE Profits ????
Self Serve Unleaded Gasoline
Las Vegas, Nevada

Lundberg Read Dates:	6-Jan	20-Jan	3-Feb	17-Feb	3-Mar	17-Mar	7-Apr
Taxes	32.1	32.1	32.1	32.1	32.1	32.1	32.1
Crude Price/Gal	41.4	41.67	40.48	39.57	39.29	44.64	46.43
Refining/ Marketing	12.91	12.55	14.24	16.04	17.44	12.89	24.53
Dealer Margins	4.23	3.48	3.25	2.53	1.67	1.54	2.93
Average Retail Price	90.64	89.8	90.07	90.24	90.5	91.17	105.99

(Refining & Marketing means Oil Company Margins before costs. ie Refining cost is approximately 7¢/ gal)
Assuming a profit on Jan. 6th, you can see that the refiners have ENHANCED profits by 11.64¢ since the spill
(Dealer Margins = Lundberg's analysis of retailers [dealers] apparent profits per gallon) **(17.3¢ in Reno !!!)**

RENO... Unleaded

Lundberg Read Dates:	6-Jan	20-Jan	3-Feb	17-Feb	3-Mar	17-Mar	7-Apr
Taxes	32.1	32.1	32.1	32.1	32.1	32.1	32.1
Crude Price/Gal	41.4	41.67	40.48	39.57	39.29	44.64	46.43
Refining/ Marketing	5.27	4.51	8.53	11.09	12.82	11.76	29.09
Dealer Margins	5.98	4.77	3.31	3.21	4.43	4.19	2.99
Average Retail Price	84.75	83.05	84.42	85.97	88.64	92.69	110.61

Source: Lundberg/ Platts

REVIEW-JOURNAL NEWSPAPER

Wednesday, April 5, 1989 ©Donrey of Nevada, Inc.

Final Home Edition
Vol. 88, No. 7 136 pages 25 cents

Exxon ready to refloat oil tanker

Las Vegas gas prices increasing

By Mary Hynes
Review-Journal

In the wake of an Alaskan oil spill, gas prices at Southern Nevada pumps have gone up 8 to 15 cents per gallon and may continue to rise dramatically, according to the Nevada Gasoline Retailers Association.

Yet it is too soon to say if the March 24 spill will result in a true shortage, said Jack Green, chairman of the association's board.

Instead, Green said, the oil refining companies are using the spill as a convenient excuse to jack up prices.

"It's our opinion they are both speculating and profiteering" in the wake of the spill, Green said.

"They're anticipating increases in gasoline and crude prices," he said, "and they're just taking it and putting it in their products right now."

Clark County and the rest of the Western states rely heavily on Alaskan crude, Arco, which ships 33 to 39 percent of all the gasoline sold in Clark County, draws nearly all of its crude from the region of the spill, said Green, an Arco service station dealer.

The spill largely has curtailed shipments from the region, Green maintained, all supplies are stored from other areas to prevent a shortage.

"Are we [illegible] what's happening," he insisted. "It's like the gas is going off at the gate and there's

Please see GAS/6A

Gas

From 1A

gone just raced to raise the prices."

Generally, it takes 10 to 60 days for an increase to [illegible] in after "something happens to the world of crude oil," said Jerome Solomon, a spokesperson for the California State Automobile Association.

Increases reported since the spill appear to be unjustified, Solomon said, noting that the price of crude has dropped.

"What happened did not justify the kinds of price increases that have been seen in our territory," which includes Nevada, Northern and Central California, she said.

At Green's Arco, prices for regular gas have increased in 12 days from 88.9 cents per gallon to 96.9 cents. Green said his profit margin has not changed, and that he is merely passing on increases from the oil refining company.

In the Los Angeles area, prices for regular gas have risen as high as $1.25 per gallon, Green said.

Other factors that could be affecting gas prices, Solomon said, include reduced oil production by OPEC and the onset of the vacation season.

Representatives of oil refining companies could not be reached for comment.

Exxon oil spill no excuse to raise gas prices now

It is a sad but true statement, but greed often comes before fairness and honesty.

The latest example has surfaced in the wake of the Alaskan oil spill.

The oil spill is a poor excuse for oil companies — and subsequently gas stations — to jack up their prices. It is a blatantly obvious attempt to gouge consumers.

While it is understood that there may be the need for a slight increase in gas prices because of the spill and its side effects, increases of 20 cents a gallon are unwarranted.

Jack Greco, chairman of the Nevada Gasoline Retailers Association, agrees.

"The pure profit motive and speculation of the oil companies jacked up the price," Greco said recently, arguing that the oil spill's impact on the gas supply has been minimal.

It is absurd that the oil companies should be making a huge profit off such a disaster, especially one created by a member of their own industry.

The gas we're buying now at the pumps was bought — and refined — at a set price before the accident.

Oil company officials say prices must be raised because of the decrease in reserves lost in the oil spill. So to keep the profit margin at a higher level, gas prices are increased, given the fact that companies will be distributing and refining less oil.

In times of tragedy, people — including oil company executives — should be working together to solve a problem, not seeking ways to make an extra buck.

Contributing to this price hike fiasco is the fact that some officials have grossly overstated the immensity of the disaster.

Yes, the 11-million-gallon oil spill was the worst in U.S. history. But no, it is not "the worst man-made disaster since Hiroshima," as Justice Kenneth Rohl proclaimed during the ship captain's arraignment in a New York court last week.

These sensational comments are precisely the reason oil companies and gas stations are getting away with raising their prices. If the American people are led to believe the oil spill was the most disastrous event in 40 years, they are more willing to submit to higher prices.

The real disaster resulting from the spill has been the marginal cleanup effort.

The spill has become an unruly beast. A full two weeks after the spill, Exxon had managed to scoop up only 4 percent of the 11 million gallons of oil.

In the meantime, the oil is killing fish, birds, sea otters, bears and deer as it decimates the environment.

President Bush took action last Friday, ordering U.S. military forces to assist in the cleanup. While it should not have taken the president so long to react, it is a positive step for him to initiate an all-out effort to clean up the mess.

He must make certain that military expenses are paid for by the offending company and not by the taxpayers.

Let's concentrate on the cleanup efforts and not use the accident as an excuse to impose unreasonable gas hikes.

Monday, April 10, 1989
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Spill forces record leap in gas price

Associated Press

LOS ANGELES — Gasoline prices rose more than a dime after the grounding of the Exxon Valdez, the greatest single price increase in the history of the U.S. gasoline market, according to a national survey.

The average retail price of a gallon of gasoline from March 17 to April 7 rose to 110.63 cents, up from the previous 100.37 cents, Trilby Lundberg, publisher of the Lundberg Survey, said Sunday. But she said there were signs prices were easing.

The prices for self-service gasoline stations, which now make up 80 percent of the domestic market, were: regular unleaded 100.96 cents, up from 90.09 cents a gallon; premium unleaded, 115.80 cents, up from 106.24 cents a gallon; regular leaded, 100.56 cents, up from 87.72.

Full service prices included regular unleaded for 126.58 cents a gallon, up from 118.72; premium unleaded for 138.07 cents, up from 130.08 cents; and 124.22 for regular leaded, up from 115.13 cents.

The increase in wholesale prices was a tenth of a penny greater than the retail increase. "It can be said it was the quickest as well as the greatest wholesale price hike in the history of the U.S. gasoline market," Lundberg said.

"Without factoring in inflation, this also was the fastest and greatest rise for retail," she said.

The average price includes all taxes, grades of gasoline and both self-service and full-service pump prices. The Lundberg Survey samples prices from 17,000 gasoline stations in the United States.

The surge in gas prices followed the brief shutoff of Alaskan oil shipments after the tanker accident temporarily closed the Port of Valdez. It has since reopened, and Lundberg said prices already were beginning to fall by Sunday.

Some distributors who sell to gasoline stations accused independent refineries of taking advantage of the spill, which briefly cut off 40 percent of California's crude supply, the Los Angeles Times reported Sunday.

"When the news got out, the refiners were all of a sudden saying they're out of gasoline," said Bill Wright, owner of Wright Oil Co. of Santee. "They raised prices as high as they could to stop the demand for their gasoline, because every gallon they sold that day was a gallon they wouldn't be able to sell the next week for a lot more money."

Lundberg defended the price rises from refineries.

"It was a price response ... stemming from actual cutbacks in crude oil and refined product, and a preventive mechanism by which the refiners did not want to run out."

The survey prices for April 7 came three weeks after the last report.

Front Page
R.J.

Gas hike largest, fastest in history

United Press International

LOS ANGELES — The price of a gallon of gasoline climbed more than a dime at the nation's pumps in the past three weeks, spurred partly by fears of shortages due to the Alaska oil spill, an oil industry analyst said Sunday.

"Retail gasoline prices nationwide showed the largest and fastest price rise in the history of the U.S. gasoline market," said Trilby Lundberg, whose Los Angeles-based Lundberg Newsletter regularly surveys more than 12,000 gasoline stations throughout the country.

Lundberg, in a telephone interview, said the average price of a gallon of gasoline, including taxes, jumped 10.24 cents from 100.39 cents a gallon March 17 to 110.63 cents April 7.

"What we have just seen is an almost instantaneous national reaction to the brief cutoff of a quarter of the nation's oil supply due to the disaster in Alaska," she said.

Independent refiners were the first to experience oil shortages — especially in California where 40 percent of the crude

See GAS, Page 8A

Gas

Continued from Page 1A

oil comes from Alaska — and prices jumped, she said.

Shortage fears accelerated the increased demand and prices continued to rise until the flow of crude oil was resumed from Alaska.

Lundberg noted, however, that there were other contributing factors to the increase aside from the spill of 10.1 million gallons of oil March 24 when the Exxon Valdez struck a reef in Prince William Sound.

"The wholesale prices were rising noticeably prior to the Alaska disaster," she said. "These price increases were the results of three elements. Cutbacks in refinery output, higher prices in the import markets ... and finally higher prices from U.S. refiners to head off possible shortages by dampening demand and thus preventing panic buying."

The survey found that the average price at self-service stations — where over 80 percent of consumer gasoline sales are made — was 100.96 cents for regular unleaded, 118.80 for premium leaded and 100.56 for regular leaded.

Although there will probably be some stabilization now that oil shipments have resumed, Lundberg said the factors that lead to price increases all year long are continuing and further pressure will come once the summer driving season begins.

"The emergency is over, however, no one should expect an immediate drop of those 10 pennies, because of factors not related to the Alaska disaster, such as the relative stronger international crude oil prices and the seasonality of gasoline demand," she said.

The only other time prices were at a level similar to the current price was in the beginning of 1980 after the Iranian oil embargo threatened supplies and sent spot markets soaring, she said.

Page 2
SUN 4-10-89

Senator METZENBAUM. Thank you very much, Senator Bryan. Happy to have your comments and your observations.

We are very pleased that the Honorable Jim Bates, Congressman from the State of California, is with us. Congressman, please proceed.

STATEMENT OF HON. JIM BATES, U.S. REPRESENTATIVE FROM CALIFORNIA

Mr. BATES. Thank you very much, Mr. Chairman. I am pleased to be here and I am pleased that you are chairing this Subcommittee, because I think your record as a consumer advocate is well known and I hope that something can be done about this problem.

I would request that a series of letters that I have had with the Administrator of the Energy Information Agency be placed in the record, and I think I will not read all of this material, but I think it will be helpful in addressing this problem.

Senator METZENBAUM. It will be included in the record.

Mr. BATES. I would like to state that the problem is a serious one, and which I just returned this morning from California and that is the number one issue on the minds of my constituents, the 44th District in the southern part of San Diego County and the City of San Diego.

In California, gasoline prices have increased from 10 cents to 27 cents per gallon. Yet crude oil prices at the wellhead have risen only two to three cents per gallon in California, and this touches on a problem that I think has been evident for some time, but this crisis I think now gives it the attention that it deserves and perhaps we can begin to deal with a serious problem.

As background, Mr. Chairman, the posted price for crude oil is important because it is generally the actual sales price used to calculate Federal windfall, previously calculated windfall profit tax and current royalties. If posted prices, the price refiners use to buy the oil from producers, is lower than fair market value, the Federal and state governments, the State of California in particular in this case, lose tax and royalty revenues.

In 1987, Chairman Dingell and I requested of the General Accounting Office a study on whether posted prices for California crude oil were at fair market value. Unfortunately, the GAO merely compiled opinions from various government agencies, without any real analysis. We recently received a follow-up letter from Comptroller General Charles Bowsher, who stated that our concerns about West Coast market "may well be valid, but to continue the analysis would involve considerable time and effort."

Mr. Chairman, this need not be the case, and the problem has been created because the Energy Information Agency has not been collecting adequate data, which the EIA is required to do under the Federal Energy Administration Act. They collect an extremely useful and voluminous amount of data on imports of foreign oil. We know almost nothing about our domestic production.

So some of the questions that are being asked today on whether the American public is truly being gouged and taken advantage of may never be able to be determined because the information has not been collected by the Energy Information Agency.

On foreign crude oil, the data that is collected is on a cargo-specific basis, including crude quality, price, type of transaction, and transportation. On domestic crude, they collect only state-level prices and volumes on their Form EIA-182.

We know almost nothing about the type of crude, the ownership, the relationship between the buyers and sellers. In fact, we know nothing about the market between the wellhead and the refiners.

I understand in 1985 there was a proposal by the EIA staff to expand the data for domestic crude. This proposal was supported by a number of Members of Congress, including Congressman Sharp, Congressman Rostenkowski, and Senator Johnston, in part because of the relevance of such data to crude pricing issues.

The IRS and Justice Department made particular reference for such data and requested it in dealing with the West Coast crude pricing issue.

However, the Administrator, Dr. Merklein, who I understand could not attend today, decided not to implement this approved proposal. Apparently their position was that the EIA could perform its duties without the additional data.

In 1987 the EIA staff prepared an excellent analysis of discrepancies between West Coast crude oil prices and crude oil prices in other producing areas of the country. The authors concluded there were insufficient causes to explain the crude oil price differences.

In response to the analysis, Chevron issued a critique claiming the analysis by EIA staff contained inaccuracies and omissions which prevented the authors from explaining the discrepancies.

The staff refuted the Chevron critique, which was finally released when I demanded to see it. However, in releasing the report, Dr. Merklein stated a resolution of the question if West Coast crude prices reflected real market values would not be worth the time and resources required. Furthermore, they stated in a letter that the kind of data needed to answer the question is just not available.

However, it was the Administrator who decided not to collect the data in the first place.

I think this indicates a serious problem within the Federal Government, the need for this information, and hopefuly this Committee's involvement will focus on this and begin to address this problem and hopefully correct this lack of information gathering.

I look forward to the results of this hearing. Thank you.

[The prepared statement of Mr. Bates and letters referred to follow:]

JIM BATES
NINTH DISTRICT, CALIFORNIA

COMMITTEE ON ENERGY AND COMMERCE

COMMITTEE ON HOUSE ADMINISTRATION

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Congress of the United States
House of Representatives

STATEMENT OF THE

HONORABLE JIM BATES

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

APRIL 17, 1989

I THANK THE CHAIRMAN FROM OHIO FOR GIVING ME THE OPPORTUNITY TO SPEAK BEFORE THE DISTINGUISHED MEMBERS OF THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION REGARDING THE RECENT GASOLINE PRICE INCREASES THAT HAVE OCCURRED AROUND THE COUNTRY SINCE THE ALASKAN OIL SPILL.

MR. CHAIRMAN, I REPRESENT THE 44TH CONGRESSIONAL DISTRICT IN THE STATE OF CALIFORNIA. LATELY, MY CONSTITUENTS HAVE SHARED WITH ME THEIR CONSTERNATION OVER THE RAPIDLY RISING GASOLINE PRICES. DEPENDING ON THE BRAND OF GASOLINE AND LOCATION, GASOLINE PRICES HAVE INCREASED FROM 10 TO 27 CENTS PER GALLON ON THE WEST COAST. YET, CRUDE OIL PRICES AT THE WELLHEAD HAVE RISEN ONLY 2 TO 3 CENTS PER GALLON IN CALIFORNIA. THE QUESTION I RAISE FOR YOU TODAY, WHICH UNFORTUNATELY I CANNOT ANSWER, IS HOW CAN THE HIGH PRICE INCREASE OF GASOLINE AT THE PUMP BE EXPLAINED WHEN THE POSTED CRUDE OIL PRICES AT THE WELLHEAD HAVE NOT INCREASED PROPORTIONALLY.

AS BACKGROUND MR. CHAIRMAN, THE POSTED PRICE FOR CRUDE OIL ARE IMPORTANT BECAUSE THEY ARE GENERALLY THE ACTUAL SALES PRICES USED TO CALCULATE FEDERAL WINDFALL PROFIT TAX AND ROYALTIES. IF POSTED PRICES (THE PRICE REFINERS USE TO BUY THE OIL FROM PRODUCERS) ARE LOWER THAN FAIR MARKET VALUE, THE FEDERAL AND STATE GOVERNMENT LOSES TAX AND ROYALTY REVENUES.

IN 1987, CHAIRMAN DINGELL AND I REQUESTED GAO TO STUDY WHETHER POSTED PRICES FOR CALIFORNIA CRUDE OIL FAIR MARKET VALUE. UNFORTUNATELY, THE GAO MERELY COMPILED OPINIONS FROM VARIOUS GOVERNMENT AGENCIES WITHOUT ANY ANALYSIS. I RECENTLY RECEIVED A FOLLOWUP LETTER FROM COMPTROLLER GENERAL CHARLES BOWSHER WHO STATED THAT MY CONCERNS ABOUT THE WEST COAST MARKET "MAY WELL BE VALID", BUT TO CONTINUE THE ANALYSIS WOULD "INVOLVE CONSIDERABLE TIME AND EFFORT."

MR. CHAIRMAN THIS NEED NOT BE THE CASE IF THE ENERGY INFORMATION AGENCY HAD BEEN COLLECTING ADEQUATE DATA WHICH THE EIA IS REQUIRED TO DO UNDER THE FEDERAL ENERGY ADMINISTRATION ACT. WHILE THE EIA COLLECTS AN EXTREMELY USEFUL AMOUNT OF DATA ON IMPORTS OF FOREIGN OIL, WE KNOW ALMOST NOTHING ABOUT OUR DOMESTIC PRODUCTION.

FOR INSTANCE, FOREIGN CRUDE OIL DATA IS COLLECTED ON A CARGO SPECIFIC BASIS INCLUDING CRUDE QUALITY, PRICE, TYPE OF TRANSACTION, AND TRANSPORTATION. ON DOMESTIC CRUDES EIA COLLECTS ONLY STATE-LEVEL PRICES AND VOLUMES ON ITS FORM EIA-182. WE KNOW ALMOST NOTHING ABOUT THE TYPE OF CRUDE, THE OWNERSHIP, THE RELATIONSHIP BETWEEN THE BUYERS AND SELLERS. IN FACT, WE KNOW NOTHING ABOUT THE MARKET BETWEEN THE WELLHEAD AND THE REFINERS.

I UNDERSTAND THAT IN 1985, THERE WAS A PROPOSAL BY EIA STAFF TO EXPAND THE DATA FOR DOMESTIC CRUDE OILS. THIS PROPOSAL WAS STRONGLY SUPPORTED BY A NUMBER OF MEMBERS OF CONGRESS INCLUDING CONGRESSMAN SHARP, ROSTENKOWSKI AND SENATOR JOHNSTON, IN PART BECAUSE OF THE RELEVANCE FOR SUCH DATE TO CRUDE PRICING ISSUES. THE IRS AND JUSTICE DEPARTMENT MADE PARTICULAR REFERENCE FOR SUCH DATA IN DEALING WITH THE WEST COAST CRUDE PRICING ISSUE. HOWEVER THE ADMINISTRATOR, DR. MERKLEIN, DECIDED NOT TO IMPLEMENT THE PROPOSAL. APPARENTLY, DR. MERKLEIN'S POSITION WAS THAT EIA COULD PERFORM ITS DUTIES WITHOUT THE ADDITIONAL DATA.

IN 1987, EIA STAFF PREPARED AN EXCELLENT ANALYSIS OF DISCREPANCIES BETWEEN WEST COAST CRUDE OIL PRICES AND CRUDE OIL PRICES IN OTHER PRODUCING AREAS OF THE COUNTRY. THE AUTHORS CONCLUDED THAT THERE WERE INSUFFICIENT CAUSES TO EXPLAIN THE CRUDE OIL PRICE DIFFERENCES. IN RESPONSE TO THE ANALYSIS, CHEVRON ISSUED A CRITIQUE CLAIMING THE ANALYSIS BE EIA STAFF CONTAINED INACCURACIES AND OMISSIONS WHICH PREVENTED THE AUTHORS FROM EXPLAINING THE DISCREPANCIES. THE EIA STAFF REFUTED THE CHEVRON CRITIQUE, WHICH WAS FINALLY RELEASED WHEN I DEMANDED TO SEE IT.

HOWEVER, IN RELEASING THE REPORT TO ME, DR. MERKLEIN STATED THAT A RESOLUTION OF THE QUESTION OF WHETHER WEST COAST CRUDE PRICES REFLECTED REAL MARKET VALUES WOULD NOT BE WORTH THE "TIME AND RESOURCES REQUIRED" FURTHERMORE, DR. MERKLEIN STATED IN A LETTER

TO ME DATED 16 FEBRUARY, 1989 THAT THE KIND OF DATA NEEDED TO ANSWER THE QUESTION IS JUST NOT AVAILABLE TO THE EIA. HOWEVER, IT WAS THE ADMINISTRATOR WHO DECIDED NOT TO COLLECT THE DATA. IT SEEMED MOST INAPPROPRIATE FOR DR. MERKLEIN TO LATER CONTEND OTHERWISE.

DR. MERKLEIN STATES IN HIS LATEST LETTER TO ME THAT EIA IS A "STATISTICAL AGENCY NOT WELL-SUITED TO COLLECT AND DISSEMINATE DATA FOR ADJUDICATORY PURPOSES." WHILE ADJUDICATION ITSELF HAS SPECIAL DEMANDS THAT MAY FALL OUTSIDE EIA'S RESPONSIBILITIES, AGENCIES WITH ENFORCEMENT RESPONSIBILITIES, SUCH AS THE IRS, NEED ADEQUATE DATA TO FORMULATE POLICY.

IN MY VIEW, IF THE EIA HAD BEEN COLLECTING THE DATA AS RECOMMENDED BY ITS OWN STAFF, THE AGENCY WOULD HAVE BEEN IN A MUCH BETTER POSITION TO DEAL WITH THE ISSUES SURROUNDING THE GAS PRICE HIKES, AS WELL AS MANY OTHER FEDERAL AND STATE ISSUES. WHILE THE QUESTION OF WHETHER POSTED CRUDE OIL PRICES IN CALIFORNIA REFLECT FAIR MARKET VALUE MAY SEEM LIKE A LOCAL ISSUE, IT IS NOT. THE ABSENCE OF EIA DATA ON THIS ISSUE INDICATES A FAILURE TO UNDERSTAND THAT MANY IMPORTANT NATIONAL ENERGY ISSUES OF THE SUM OF THE "LOCAL" ISSUES EIA IS EMPOWERED BY LAW TO ADDRESS. GREATER EFFORT IN THAT AREA WOULD SERVE US WELL NOW.

Department of Energy
Washington, DC 20585

February 16,1989

Honorable Jim Bates
House of Representatives
Washington, D.C. 20515

Dear Mr. Bates:

This is in response to your letter of January 9, 1989, requesting comments on the Chevron, U.S.A., Incorporated (Chevron) critique of the feature article, "California Crude Oil Price Levels," which appeared in the Energy Information Administration's (EIA) Petroleum Marketing Monthly in April 1987.

As you may recall, the purpose of that article was to "...explore some of the factors which may contribute to observed differences in California crude oil prices and refining profitability compared to the rest of the country." The referenced EIA article does not come to a definitive conclusion as to why California gross margins are larger than those east of the Rockies. The fact that the period under review is characterized by severely depressed refinery markets, with negative returns on Gulf-Coast refining operations, does not help in clarifying the situation.

In any event, the General Accounting Office (GAO) also initiated a study of some of the same issues and requested Chevron's comments on the EIA article. As a result, the GAO requested our comments on the Chevron critique.

In the enclosed paper, one of the authors of the original article has attempted to identify additional data and provide additional insight which would explain the rationale for some of the material presented in the original article. These comments, far from being exhaustive or comprehensive, are focused on the Chevron comments referring to the original EIA article. The questions involved in trying to understand such seemingly simple issues as the differences between the California and Texas crude oil markets are wide-ranging and complex. In retrospect we may have been remiss by not indicating in the original article that it was intended to encourage thought and discussion and in failing to properly emphasize that the results of the analysis are inconclusive.

The kind of detailed information which would be necessary to fully address questions bearing on the differences between Petroleum Allocation for Defense District V (PADD V) and others is just not available to the Energy Information Administration. Examination of each new facet seems to lead to new avenues to be explored, leading us to believe that the time and resources required would not be justified, given the near-certainty that this expenditure would not produce more reliable or definitive results. This conclusion should not come as a surprise, since both the General Accounting Office and the Internal Revenue Service have expended considerable effort, resulting in a similar conclusion.

If you have any questions, please call on me.

Sincerely,

H. A. Merklein

Dr. H. A. Merklein
Administrator
Energy Information Administration

Enclosure

JIM BATES
44th DISTRICT, CALIFORNIA

COMMITTEE ON ENERGY AND COMMERCE

COMMITTEE ON HOUSE ADMINISTRATION

CHAIRMAN
SUBCOMMITTEE ON PROCUREMENT AND PRINTING

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Congress of the United States
House of Representatives

March 2, 1989

Dr. H. A. Merklein
Administrator
Energy Information Administration
Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Dear Dr. Merklein:

Thank you for sending the excellent staff paper addressing the criticisms of EIA's April 1987 article on West Coast crude oil prices by Chevron, U.S.A., Incorporated. However, I find your cover letter puzzling. You state that a resolution of the question of whether West Coast crude prices reflected real market values would not be worth the "time and resources required." Yet, as you no doubt are well aware, the posted prices are the basis for calculating both federal and state royalties and the federal Windfall Profit Tax. At issue are hundreds of millions of dollars in federal and state revenues. I do not understand why you find the matter unworthy of your time and resources.

Your comment that the General Accounting Office and the Internal Revenue Service were unable to produce a reliable or definitive answer to the question is misleading. Granted the GAO reached no conclusion, but its report (GAO/GGD-88-114) was little more than a compilation of the opinions of various government agencies without any analysis. The IRS is another matter. Last July IRS issued a deficiency notice against ARCO based on its ANS prices for over $1 billion in Windfall Profit Taxes, plus interest. As you are well aware, during the period of the WPT ARCO's reported prices for ANS crude landed on the West Coast were higher than the posted prices of comparable California crudes. While the WPT implications of this for California prices is a legal question, their action from an economic prospective certainly puts the IRS in the camp of those who refuse to take the California posted prices at face value as was acknowledged in the GAO report. After all, as ARCO has long argued, if California crude oil postings reflect fair market values, then the IRS deficiency notice makes no sense.

More troubling is your contention that EIA does not have the detailed information to fully address the question. According to Energy Committee staff, in 1985 there was a proposal to expand the data collected under Form EIA-182 to collect gravity and sulfur data for domestic crude oils. This proposal was strongly supported by a number of members of Congress (including Congressman Sharp, Rostenkowski, W. Hensen Moore and Senator Johnston) in part because of the relevance os such data to crude pricing issues. In commenting on the proposal both the IRS and the Department of Justice made particular reference to the need for such data in dealing with the West Coast crude pricing issue.

It was your decision not to implement the proposal. Apparently, it was your position that EIA could perform its duties without the additional data. It seems most inappropriate for you to now contend otherwise.

Since you have disassociated yourself from your staff's work on this issue, I would appreciate your own views on the following questions: Is there a convincing market based explanation for the West Coast crude prices? What is your explanation for the disparity between West Coast crude prices and the prices of similar crudes in other markets? Between refining margins on the West Coast and such margins in other markets? What additional data do you believe would be necessary to resolve the issue of underpricing of West Coast crude?

I would appreciate hearing from you at your earliest convenience.

Sincerely,

JIM BATES
Member of Congress

JB:jh

cc: Admiral James D. Watkins

Department of Energy
Washington, DC 20585

March 20, 1989

The Honorable Jim Bates
House of Representatives
Washington, D.C. 20515

Dear Congressman Bates:

I appreciate your continuing interest in our work as expressed in your letter of March 2, 1989.

I am sensitive to your concern about Energy Information Administration (EIA) data and the relevance some of them might have for certain tax collection processes, including those involving royalties and windfall profits. However, the EIA is a statistical agency not well-suited to collect and disseminate data for adjudicatory matters.

EIA attempts to monitor energy market developments worldwide, by type of energy. Much information is collected, aggregated, and published. But that which is collected is not pointed to use in particular legal proceedings. We could never anticipate in advance all the detail that would be appropriate for such matters, and to try to do so would be beyond our resources and mission. The information we provide may occasionally be used as background for legal proceedings. However, only the discovery process, bound by considerations of due process, will resolve particular issues of dispute.

The decisions made at EIA regarding the range and level of detail in our data collections are a matter of judgment. In forming that judgment, consideration is given to the relevance of particular data for important national and regional issues and to the costs of collecting such data, viewed from both an agency and respondent point of view. As the agency's efforts evolve, some decisions may be more or less supportive of needs for information that are other than solely statistical. However, these requirements do not dictate the nature of data collection decisions within EIA.

EIA does collect data relevant to the questions you raised in your letter. EIA collects data appropriate for monitoring the course of market developments with respect to crude oil. The market for crude oil is a global market wherein crude oil flows

to destinations in accordance with prevailing demand and supply patterns. Decreases or increases in production are reflected in corresponding price movements. As can be seen in the attached figure, Alaskan North Slope (ANS), Texas, and California crude oil prices have exhibited nearly identical price changes since the decontrol of U.S. crude oil prices in 1981. The only exception was a very slight rise in California prices between 1984 and 1985 while other oil prices registered a slight decline. This is the period covered by the Petroleum Monthly Marketing (PMM) article and indicates that minor temporary deviations from market fundamentals do occasionally occur but tend to be short lived.

In California, because of its market infrastructure, indigenous crude oil is at an overwhelming transport cost disadvantage and tends to be utilized largely by PADD 5 refineries. Also, PADD 5 is a crude surplus region due to the amount of Alaskan oil production. ANS crude oil is used extensively in California; however, a significant portion of output must be sold elsewhere, but may be sold only in the United States. Accordingly, the price of crude oil in California generally reflects a $3 per barrel transport cost differential between Los Angeles and the Gulf, the closest economic U.S. market, plus quality differentials. The data in the PMM article serve to indicate that occasional short-term deviations from fundamental market forces can and do occur, but that even in such episodes the deviations tend to be of small magnitude.

The gross refining margins do appear higher in California than in Texas. However, measurement difficulties and omitted costs can affect the assessment of differences in refining margins. For example, the gross refining margin must cover the costs of distribution and marketing to the point of sale. The point of sale may be at the refinery gate or at the refiner's retail gasoline outlet. Systematic differences in either the typical distribution methods or the underlying costs of distribution in different areas would be reflected in systematic differences in gross refining margins. Gross refining margins must also recover the investment costs associated with those refineries, over the long run. This implies that such differences in refineries as size and sophistication will be reflected in gross margins.

Even after adjusting for the measurement problems and omitted costs, if it were found that refiner margins in California were higher than those in Texas, such a finding would not necessarily indicate that margins in California were excessive. In order to assess deviations from competitive norms, rate of return data should be examined. Financial data for major petroleum companies reporting to EIA's Financial Reporting System (FRS) indicate that the return on investment (ROI) (measured as operating income divided by net property, plant, and equipment) for U.S. refining/marketing operations has been lower than the overall ROI of major petroleum companies except in 1986 when there was little difference. Until 1987, the refining ROI for California-based

refiners was generally higher than that of other refiners, but these operations have been less profitable than other areas of petroleum investment generally. Further, the overall corporate rates of return for major petroleum companies have been noticeably below those of other industrial companies such as the Standard and Poor 400 corporations. These comparisons indicate that refining in general, as well as in California, failed to reach the competitive levels of industrial America at large.

The preceding discussion identifies certain questions beyond those addressed in the original PMM article which would be relevant to understanding differential cost and price behavior in the California market. The issue of "underpricing" is not addressed here. Questions relating to "underpricing" have a legal connotation which relates to particular company transactions at particular points of time. Such information is more appropriately developed in the context of a judicial discovery, for example, rather than in the context of statistical data collection.

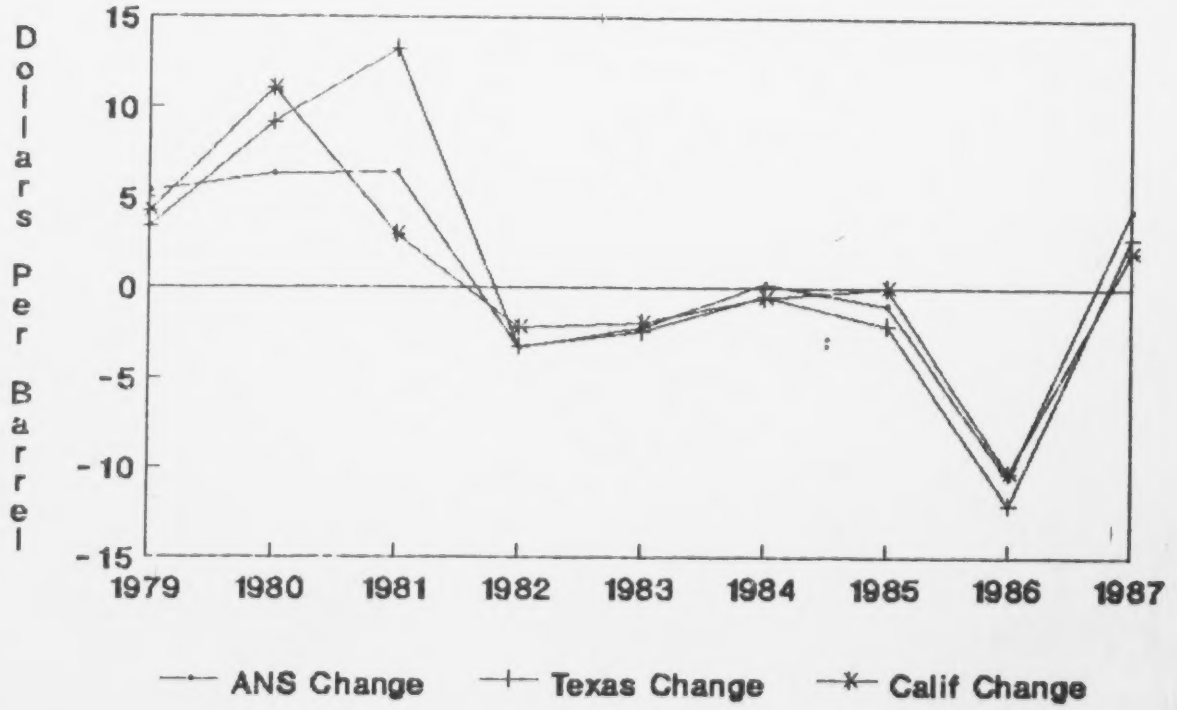
Sincerely,

H. A. Merklein

Dr. H. A. Merklein
Administrator
Energy Information Administration

Enclosure

Annual Change in Crude Oil Prices
ANS, California, and Texas



JIM BATES
4th DISTRICT, CALIFORNIA

COMMITTEE ON ENERGY
AND COMMERCE

COMMITTEE ON HOUSE
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Congress of the United States
House of Representatives

April 17, 1989

Dr. H. A. Merklein
Administrator
Energy Information Agency
Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Dear Dr. Merklein:

I appreciate your efforts to respond to my questions regarding the West Coast crude oil pricing issue. I find that after studying your letter of March 20, 1989, I continue to have problems with your position.

The central question remains whether California posted prices can be explained by normal market forces. A fair reading of the two EIA staff papers leads to the conclusion that the conventional explanations offered by the industry are without support.

Your letter, like your previous correspondence, takes issue with this conclusion but again offers no substantive evidence. Your letter includes a figure which is intended to show that crude prices in California, Texas, and Alaska respond "nearly identical[ly]" to global market movements. I do not understand what this shows about the structure of both relative and absolute levels of West Coast crude prices. It would indeed be a remote market that did not respond to world-market changes of the magnitude that occurred in this period. But changes in price are not the issue; it is the price levels and overall price structure that are in question. The fact remains that California crudes have, and continue to be, priced far below crudes elsewhere even after adjustments for quality differences.

You repeat the argument that California prices can be explained by the oversupply of ANS crude. But you make no effort to deal with the evidence to the contrary presented in the February staff paper. You assert that there is a three dollar per barrel transportation differential between Los Angeles and the Gulf. However, EIA's original article reiterates the often observed fact that, under high marginal tax rates, the marginal cost of moving ANS oil past California to the U.S. Gulf was only a few cents per barrel after taxes. Even with Windfall Profit Taxes no longer in effect, spot prices for ANS in the Gulf are now only 50 to 60 center per barrel higher than in California. That indicates

that the after-tax effective transportation cost of movement to the U.S. Gulf from the California area, at least for ANS producers, is substantially lower than the three dollars per barrel cited in your letter.

You concede that gross refining margins are higher in California than in Texas. I do not understand how this could be the case since a large portion of the supply produced in Texas must travel thousands of miles to the upper Midwest and East Coast. It is hard to imagine that higher costs could be incurred within California.

If as you assert, "...because of its market infrastructure, indigenous [California] crude oil is at an overwhelming transport cost disadvantage...", one would expect, in a competitive environment, the prices of California refined products to be substantially lower than elsewhere unless higher costs are incurred in refining and marketing in California. But we have been offered no substantive evidence of such higher costs. So the only appropriate conclusion is that demand determines refined products prices while some flaw in the market system prohibits crude oil prices from rising to its free market value.

Your reference to the Financial Reporting system (FRS) data does not seem to add anything of substance to the question. Less than forty percent of the refinery assets of the three largest California based refiners are actually located in California. If these are the ones which you use as the basis for your data, it is hard to see how any conclusion can be drawn from such data about their rates of return on their California refining assets. The reference to the industry's rate of return in comparison to all other industries are irrelevant.

You are, of course, correct in that the underpricing of crude oil should be reflected in higher rates of return for California refiners. Indeed the public evidence in the first Long Beach case demonstrates this. During the 1970's the crude producing divisions of several major oil companies complained to their management that the artificially low posted prices distorted the relative profitability of crude production in comparison with refining. While the distortion was quite significant, it is improbable that it would have appeared at the level of aggregation used in the FRS program. The aggregation of refining together with marketing data by itself would preclude any meaningful analysis of this issue.

The most troubling part of your letter, however, deals not with the substance of the West Coast pricing issue, but rather with your conception of EIA's responsibilities. Your letter states that EIA is a "statistical agency not well-suited to collect and disseminate data for adjudicatory matters." This would imply that EIA has no obligations

towards agencies that have enforcement functions. This seems inconsistent with the statutory responsibilities of the agency. While adjudication itself has special demands that may fall outside EIA's responsibilities, agencies with enforcement duties, such as the IRS, need adequate data to formulate policy. Here EIA has a clear responsibility. The Federal Energy Administration Act, as amended, requires EIA to provide for the energy information needs of all government agencies. The fact that the data could be used to serve tax collection purposes is irrelevant. EIA has no authority to avoid issues with "legal connotations."

I am disturbed by your implication that EIA's concerns are limited to a global and national level. Again I find this inconsistent with the requirements of the law which make a number of references to state and regional markets. (For example, Section 56 (b) (1) of the Federal Energy Administration Act.) Certainly the California crude market is of sufficient size and importance to deserve your serious attention.

Your letter states that, "the range and level of detail in our data collections are a matter of judgement." Perhaps judgement is the issue here. Even after Congressional criticism of EIA's failure to collect anything more than state-level prices and volumes on its Form-182, and even after an embarrassing failure to timely assess the effect of the 1986-1987 price crash on domestic production, we still know more about our foreign imports than we know about our domestic production.

The absence of EIA data directly relevant to explaining the California crude price structure underlines a failure to understand that many important national energy issues are the sum of the "local" issues EIA is empowered by law to address. It is important that EIA maintain a global perspective, but not to the exclusion of the domestic detail that Congress authorized it to address through mandatory data collection. Greater efforts in that area would serve us well now.

Sincerely,

JIM BATES
Member of Congress

cc: Honorable Admiral James D. Watkins
Honorable Phil Sharp

Senator METZENBAUM. Thank you very much, Congressman Bates, for introducing into the hearing the concerns about the EIA information and the difficulty of obtaining accurate data in that respect. And we are very pleased and we look forward to working with you in the House as this matter develops.

Thank you very much.

Our last witness as part of the opening statements is the Honorable Gray Davis, Controller of the State of California. Happy to see you and happy to have you with us, Gray.

Let me say that, if any of the Senators have to leave or the Congressman, let me just ask if any of the members of the Committee have any questions for either of the Senators or the Congressman.

Senator MCCLURE. Mr. Chairman.

Senator METZENBAUM. Senator McClure.

Senator MCCLURE. Mr. Chairman, I do not have any questions, but I do want to comment that as we are looking at the background of price increases, there are some other evidences of reasons why it might occur.

And while the witnesses are here, several have commented upon it and I would like to ask or at least call attention to the Weekly Petroleum Status Report for the week ended April 7th, published by EIA, and referred to in two charts. One appears on page 19—that is world oil prices [indicating] and you will notice that—you cannot see it from there, I am certain, but it starts in 1987, through 1988, and into 1989.

So the price increase we are seeing in gasoline currently is occurring at the same time we see this dramatic increase in the price of crude oil on the world market, the low being at about ten dollars a barrel and the high being $17.51 a barrel. That is not the high. It peaked at over $18 a barrel.

So there is a background against which the oil price is rising and the gasoline price is rising.

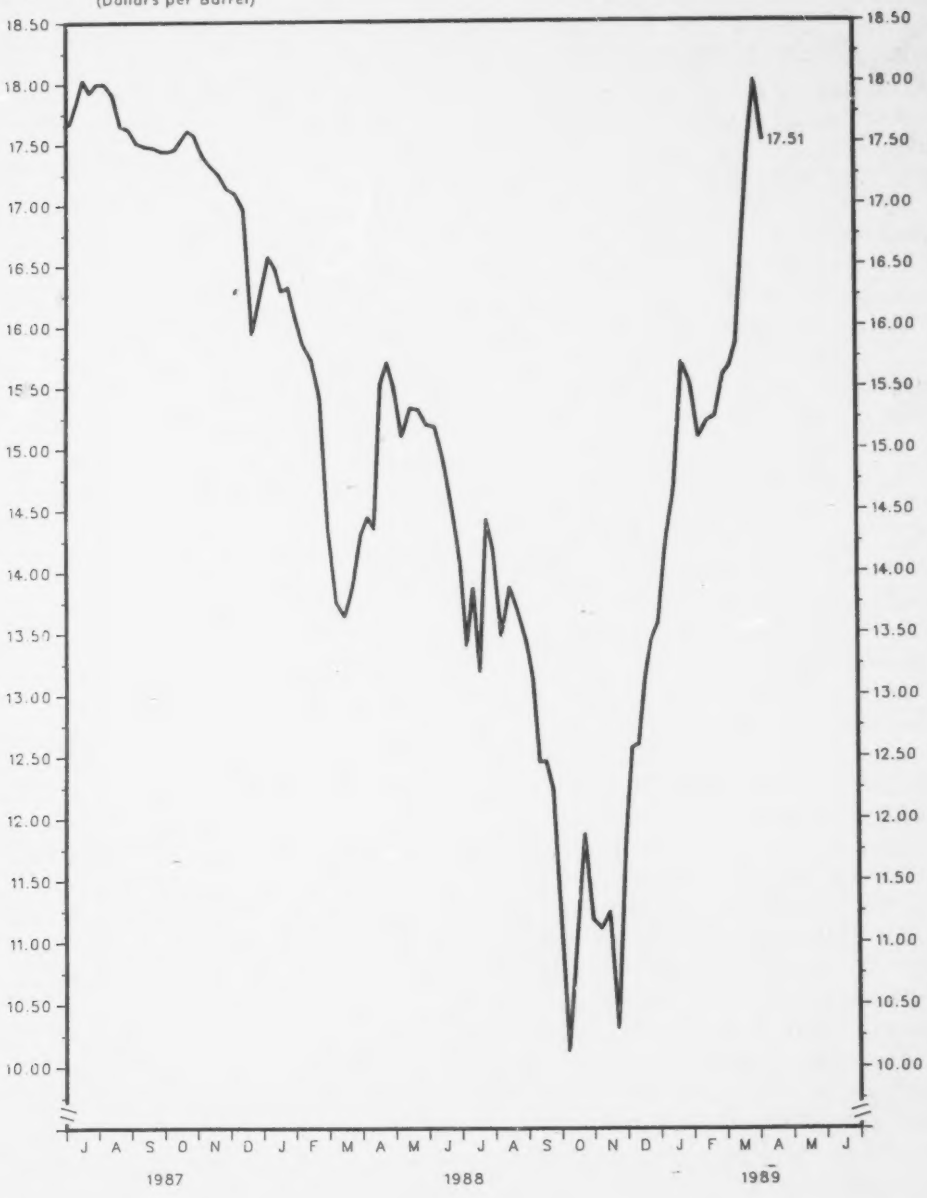
Page 21 of that report also has in it "Spot market product prices in the Rotterdam market and in the New York market" in dollars per barrel. And again, I know you cannot see it, but I call your attention to the fact that—and again, these are also the same time period, 1987 through April of 1989.

There is a very steep rise in the gasoline price on both the Rotterdam market and the New York market, which somewhat parallels the very steep rise in crude oil price. And I thought that it might be at least worthwhile to mention that while the witnesses were still here.

Senator METZENBAUM. We thank the Senator from Idaho, and those charts will be included in the record.

[The information referred to follows:]

Figure 10 World Crude Oil Price[1]
(Dollars per Barrel)



1 Average price (FOB) of internationally traded oil only, weighted by estimated export volume.

Source: See Sources Section of this publication.

As Of 04/07/89 Weekly Petroleum Status Report/Energy Information Administration

Spot Market Product Prices

Figure 11A. Rotterdam Market
(Dollars per Barrel)

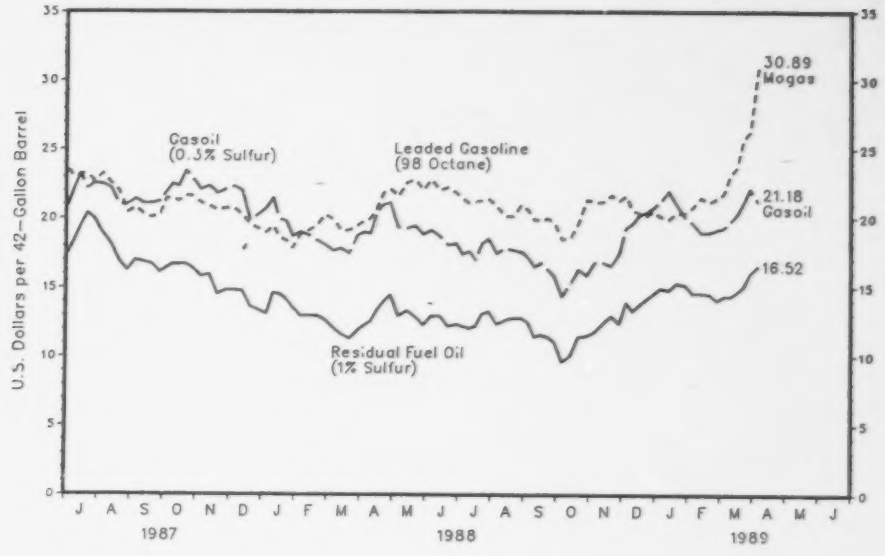
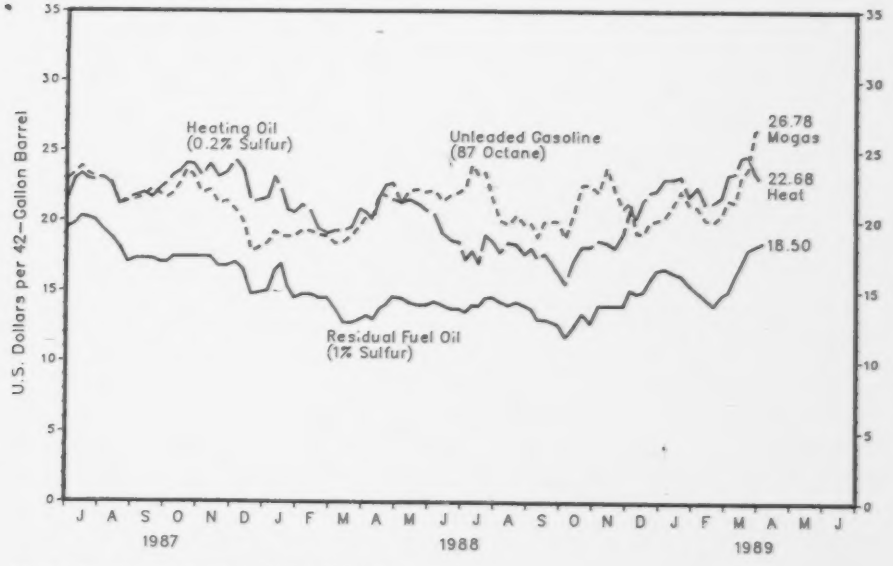


Figure 11B. New York Market
(Dollars per Barrel)



Source: See Sources Section of this publication.

Senator NICKLES. Mr. Chairman.

Senator METZENBAUM. Senator Nickles.

Senator NICKLES. Just one quick question to Congressman Bates. You mentioned that you have been working on trying to obtain this information for some time, and I think I heard you state that one of the reasons why you were concerned about the posted prices in California was because from the posted prices is where you get your gross production taxes, et cetera.

Were you concerned that posted prices were too low and not generating the revenues that were anticipated? Maybe it is a better question for the Controller.

Mr. BATES. I think Controller Gray Davis from the State of California will address that, and he has been working on that issue as well.

But I think it is clear that California crude oil posted prices are below the national average, and there is some assumption that they are low because of the attempt to pay less royalties to the State and to the Federal government in a shortage of the billions of dollars if it were to be computed out.

So I think clearly that is a concern, and it cannot be answered without the data that has not been collected. There are lawsuits on this issue. There is a great deal of effort being put into trying to get to the bottom of this question.

Senator NICKLES. So you have been working to try to see if you could not raise posted prices, posted prices in California?

Mr. BATES. It is not my function to raise or lower prices. I am simply trying to find out why it is lower. And no data is available to justify it. I think that is an alarming situation.

Senator NICKLES. I can tell you again, California is a producing state, so is Oklahoma and Louisiana and others. And when you are looking at a posted price of $13, you are looking at significantly less gross production tax than what you will be looking at, say, in today's market at a posted price of $18.50 to $19.50.

So I mean, it is just pretty—the gross production taxes will tell you exactly what the producers were paid. It is very easy to figure.

Were you assuming or guessing that there was fraud or something involved, or that the state tax collection method was——

The CHAIRMAN. Mr. Davis' statement will deal with this.

Senator NICKLES. I just found it kind of interesting, hearing that we are having to somewhat characterize the gouging that the oil industry is doing, that we also have a panelist who is talking about the prices have not been high enough in the last year to meet your estimates because the gross production tax was less than what you had hoped it might be.

STATEMENT OF HON. GRAY DAVIS, CONTROLLER, STATE OF CALIFORNIA

Mr. DAVIS. Senator, if I can respond to that.

Senator NICKLES. Please.

Mr. DAVIS. Californians are faced with a double whammy. We do have artificially low crude prices, which deny states, the Federal government, and other producers a fair return on their market value. So the royalties we are getting in the State of California and

you are getting for the Federal government are less than they should be.

But on the other hand, the California consumer is paying more than consumers in the rest of the country for gas at the pump. We think the only explanation lies in the greed and monopolistic practices of the major oil companies.

I do not make that allegation lightly. My office brought a suit back in 1975 against the major oil companies for their monopoly control over transportation mechanisms in California.

Senator NICKLES. I do not want to interrupt your statement, but I find this quite interesting. You are complaining because the crude oil prices are too low in California and you are also complaining that the retail prices are too high.

Mr. DAVIS. Precisely.

Senator NICKLES. So you want to raise the crude oil prices and——

Mr. DAVIS. The problem lies in the excessive and unwarranted profits that refiners make. And as you know, the oil industry is vertically integrated and they are taking refinery profits almost three times as high as are taken on the Gulf Coast.

That is why I would like to see the Federal Trade Commission and the Department of Justice investigate the West Coast oil market, because I think the Federal government and the states are denied a fair return and I think the consumers are paying more than the rest of the country. So it is just totally inexplicable and unfair.

The CHAIRMAN. Why don't we get Mr. Davis to go ahead and make his statement in chief at this time. It is fairly short and deals with your very question.

Senator NICKLES. Okay, please proceed.

The CHAIRMAN [presiding]. So why don't you proceed. We are very glad to have you here, Mr. Davis, Controller of the State of California.

Mr. DAVIS. I will summarize my written statement. In short, I am hoping that this Committee can enact legislation and call upon the appropriate Federal agencies to stop the California consumer from being gouged—and I think he is being gouged, more significantly than consumers in the rest of the country.

To be specific, after the Valdez accident price increases in California went up as much as 49 cents a gallon in Los Angeles. By about April 13th they were down to 25 to 30 cent increases.

And as you have heard from other witnesses, that is significantly higher increases than consumers in the rest of the country have experienced.

Equally important, Mr. Chairman, is my belief that there is no marketplace explanation for these unwarranted price increases. As others have said, the price of crude oil increased only three or four cents per gallon and the inventories are approximately the same as of April 7th as they were a year ago, about a 54-day supply compared to a 55-day supply in 1988.

So the only apparent explanation lies in the greed and monopoly power of the major oil companies over transportation of crude on the West Coast. And specifically, they all have their own pipelines. They do not treat them as common carriers, even though the Min-

eral Leasing Act requires them to do so if those pipelines cross Federal lands.

As I said in response to Senator Nickles' statement, I do not make that allegation lightly. We have been in court for a long time on our charge that the oil companies are involved in monopolistic practices, without, I might add, very much help at all from Federal agencies.

To summarize the next portion of my testimony, the oil companies have managed to keep the posted price for crude lower than crude prices in the rest of the country. Yet the consumers are paying more. The difference lies in the refinery profits available to the major oil companies, which recently were about three times higher on the West Coast, to be specific $6.99 compared to $2.60.

Or as I said before, we have the unfortunate situation where our consumers are paying more, but the state and Federal government are getting less than their fair share in terms of royalties.

Now, what interest would the majors have in pricing crude oil below its fair market value? Their interest lies in the fact that they are net producers—excuse me, purchasers, net purchasers of crude, and they wanted to evade the windfall profits tax when it was in place to keep their costs down and their profits up.

As many of you know, the Internal Revenue Service has finally issued a windfall profits tax deficiency against Arco, in the amount of $1.2 billion for just a portion of the time and production when the windfall profits tax was in effect. And that $1.2 billion claim does not include the lost royalties, taxes, and penalties that Arco might be liable for if the IRS wins its case.

Yet, despite all the evidence of undervaluation of West Coast crude, most of the Federal agencies involved in this issue which should have been active have either been sitting on their hands or actively trying to protect the major oil companies.

Let me give you just a few examples of what I mean. First, the Department of Justice. My office approached the Department of Justice when we first filed our antitrust suit and we were told, not too politely, to get lost.

I must admit, however, that recently under the Bush Administration there does seem to be some interest in this issue by the Department of Justice, and hopefully they will finally do something.

Next the Department of Interior, and quite frankly, Mr. Chairman, I have no idea why this Department is paid for with public funds, because they rarely act in the public interest. In fact, their primary interest seems to be in protecting the major oil companies from, first, complying with the common carrier requirements of the Mineral Leasing Act, from paying the royalties to the state and Federal government, from obeying the environmental laws you pass, and from acting responsibly to prevent our coastline from being defiled by oil slicks.

Now, the Department of Energy. It is true that recently two staffers from the Department of Energy Information Agency were allowed to publish papers providing economic explanations of the major oil companies of why the West Coast crude oil was undervalued. But their Director has refused to collect the information that you, Senator Johnston, asked and that others felt was necessary to adequately monitor the oil industry.

I could go on and on, but I think you get a sense of why we feel so hard-pressed in California and why we feel it was necessary to go to court to get justice for the California consumers.

And if I could just leave you with a few recommendations. I do not believe the California consumer will ever be protected until the monopoly power of the major oil companies is broken, and I do not think the Congress should permit any drilling on the Outer Continental Shelf of the West Coast until this monopoly power is broken, for, among many reasons, we will pay the full cost of the environmental effects of that drilling.

As you know, the industry recently won permission to reduce the environmental standards for drilling off the West Coast. Given the prevailing winds, you know that pollution is going to come onshore and we are going to have to either simply absorb it, grin and bear it, if you will, or pay the additional costs of cleaning up that pollution.

Now, if I could just make a couple of recommendations and I will stop. I believe you should press the Federal Trade Commission and the Justice Department to investigate the oil market, and you should press them to apply antitrust laws.

One word, Senators, if I may, in my hat as a member of the State Lands Commission, and I alternate every year as the Chairman of that—that is the authority responsible for drilling in state waters off the coast of California—I believe that the oil industry is totally unprepared to handle an oil spill of the magnitude of Valdez off our coast.

I would recommend that you do not permit any drilling in the OCS until two new laws are passed. First of all, I think you should insist on a Superfund with every leasehold sale of $100 million, paid for entirely by the oil industry. That would be an account that the Coast Guard, state and local agencies could draw down upon if there is a major disaster.

Senator METZENBAUM. You said million, not billion, did you not?

Mr. DAVIS. No, a $100 million Superfund on each leasehold sale. As I said, that would be a pool of money that state, Federal, and local agencies could draw down upon if there was a major disaster.

My chief deputy, as well as members of the State Lands Commission, went to Alaska, and they believe that one of the reasons the Coast Guard did not act sooner than it did was the cost of going in there to act more quickly. So a Superfund would obviate any cost problems.

Secondly and finally, I think you should put the Coast Guard immediately in charge of all oil spills and oil emergencies. Right now, as you know, the offending oil company is in charge, and I really believe that putting them in charge is not unlike asking a criminal to prepare and oversee a restitution plan for his victim.

They have no desire to magnify or exaggerate the problems caused by their own negligence. Just the opposite. Put the Coast Guard in charge. They could act in the public interest.

And finally, I would hope you could urge the President to visit Alaska himself and see the devastation, to see how unprepared the oil companies were, and to see how chaotic to date the cleanup efforts have been.

Thank you, sir.

[The prepared statement of Mr. Davis follows:]

TESTIMONY OF
HONORABLE GRAY DAVIS
CONTROLLER OF CALIFORNIA
April 17, 1989
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

Mr. Chairman, the recent sudden increase in gasoline prices proves what California has been saying for some time. The West Coast crude oil market is operated as a monopoly by the major oil companies to the detriment of the general public. After the Valdez spill, the wholesale spot price of regular and unleaded gasoline in Los Angeles went up 49 cents a gallon, although it seems to have settled down to about a 28.5 cents increase.

This price increase cannot be justified by crude oil price increases on the West Coast after the spill. They only went up between 3 - 4 cents a gallon. Nor can this price increase be justified by shortages of either crude or gasoline. According to data I obtained from the American Petroleum Institute, supplies of gasoline and crude in California on April 7, 1989 were about the same in California and the rest of the country as they were on the same date in 1988.[1] The monopoly power of the major oil companies over transportation of crude on the West Coast and their ability to cut off the independent refiners goes a long way towards explaining the sudden price increase.

I don't make the monopoly allegation lightly. The State has spent literally millions of dollars since 1975 when we filed the

[1] See attached charts.

first Long Beach antitrust case[2] trying to protect the public from the situation we now face, without, I might add, any assistance from the federal government agencies that are supposed to be concerned about oil pricing and monopolies.

The major oil companies have used their control over crude oil transportation on the West Coast to keep the posted price for California crude much lower than crude prices elsewhere in the United States. Yet, product prices for California are higher than in the rest of the U.S.. For example, on April 13, 1989, West Coast refiners had gross refining margins almost three times higher per barrel than refiners on the Gulf Coast ($6.99 v. $2.60).[3] To put it another way, consumers on the West Coast are paying more for gasoline than consumers in the rest of the country, but the producers, the State and Federal governments are not receiving fair market value for their crude.[4]

Why you ask would the majors price crude oil below its fair market value? Because they are net purchasers of crude and they wanted to evade the windfall profits tax in order to keep their costs down and their profits up.[5] The IRS has finally issued a

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[2] See the attached briefs filed by Long Beach with the Ninth Circuit which describe the case and the evidence.

[3] See attached chart for calculation.

[4] See my submission to the Department of Commerce on the export of West Coast crude oil and the charts and graphs prepared for me on this issue.

[5] See attached paper by Henry M. Banta and Martin Lobel on Windfall Profits Taxes and the Arthur D. Little paper on California crude pricing.

windfall profits tax deficiency assessment for $1.2 billion against ARCO for just a portion of the time and production when the windfall profits tax was in effect. And that $1.2 billion does not include the lost royalties, taxes and penalties that they may be liable for if the IRS wins its case.

Yet despite all the evidence of undervaluation of West Coast crude oil, most of the federal agencies which should have been active have been either sitting on their hands or actively trying to protect the major oil companies. Let me just list some examples to give you a flavor of what has been happening.

Department of Justice: We approached the antitrust division with our evidence before we filed the first Long Beach case and were told, not so politely, to get lost. I must admit, however, there is a glimmer of hope under the new Administration because they have recently expressed some interest in the issue. May be they will finally do something.

Department of the Interior: Quite frankly, I was never sure why the public was paying them since they appeared to exist for the sole purpose of protecting the major oil companies from obeying the common carrier requirements of the mineral leasing act,[6] from paying the money they owed in royalties,[7] from obeying the environmental laws and from acting responsibly to prevent our

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[6] See attached letter from the Department of the Interior to the California Controller.

[7] See Department of the Interior Inspector General's Reports, attached.

coastline being befouled by oil spills.[8]

Department of Energy: Although two Energy Information Agency staffers were allowed to publish papers[9] that rebutted the economic explanations of the major oil companies why West Coast crude oil was undervalued based on those companies own data, the Director, Helmut Merklein, has refused to collect other data that Senator Johnston and others felt was necessary to adequately monitor the oil industry.

I could go on and on but I think you have a flavor of why we in California were forced to act to protect the public and why we feel that the public has been victimized by the major oil companies. We stand ready to help you in any way we can but I'd like to leave you with two thoughts:

1 - Until the monopoly power of the major oil companies is broken the public will remain vulnerable to these unjustified price increases and

2 - Until the monopoly power of the major companies is broken we should not even think of leasing the OCS off the West Coast because we, the public, will have to bear all the environmental costs, but will not receive fair market value for our assets because they will reflect the artificially low price of West Coast crude.

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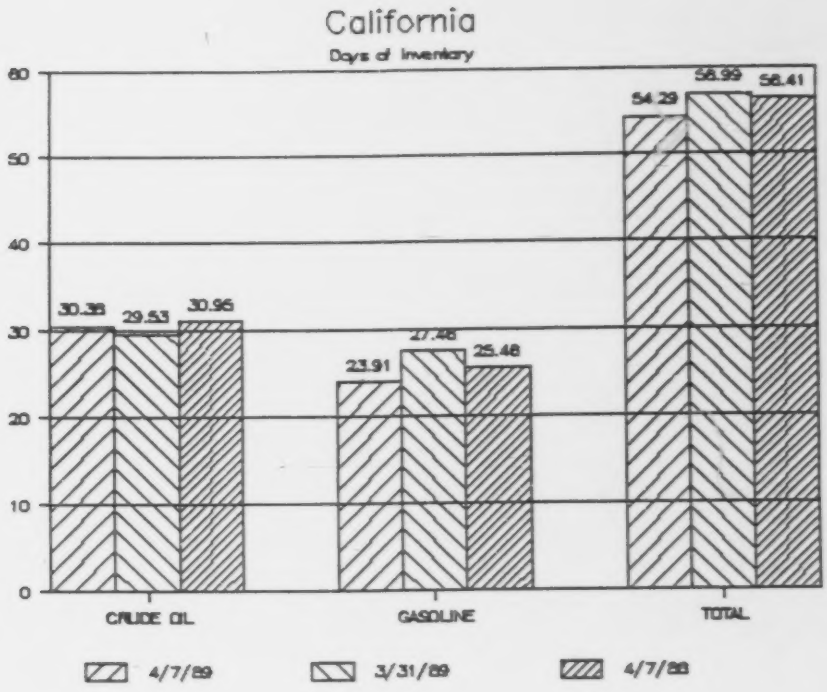
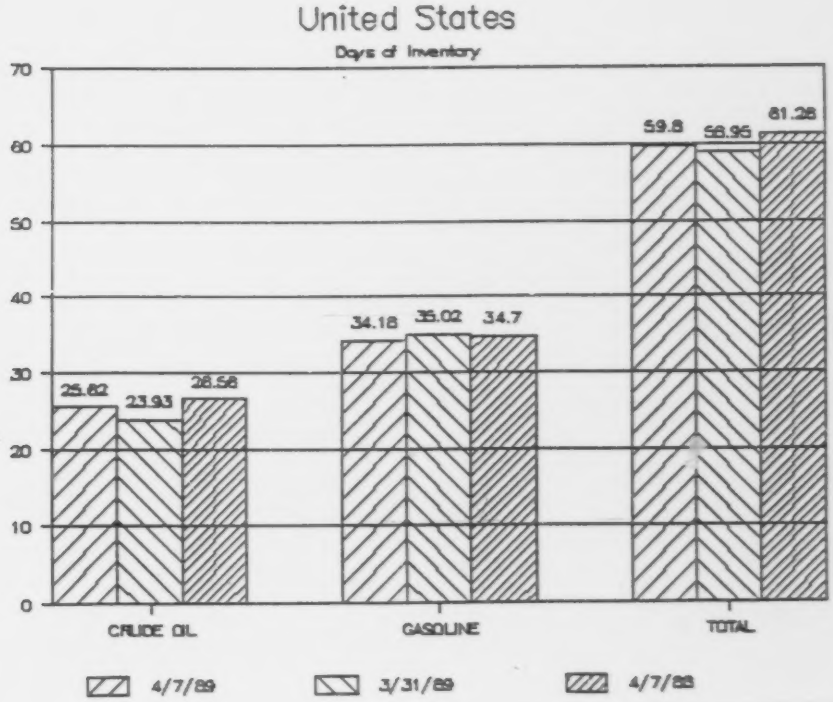
[8] See letter of Congressman Levine and others to President Bush, press release and attached memo from Assistant Secretary Griles.

[9] See attached papers by Charles P. Shirkey and Robert A. Speir and Chevron's comments.


California
Days of Inventory
60
50
40
30
20
10
0
30.35
29.53
30.95
23.91
27.46
25.48
54.29
58.99
58.41
CRUDE OIL
GASOLINE
TOTAL
4/7/89
3/31/89
4/7/88


United States
Days of Inventory
70
60
50
40
30
20
10
0
25.82
23.93
26.58
34.18
35.02
34.7
59.8
58.95
61.28
CRUDE OIL
GASOLINE
TOTAL
4/7/89
3/31/89
4/7/88

WEST COAST/GULF COAST REFINING MARGINS

	West Coast	Gulf Coast
Gross product value	28.74	24.20
Crude price	17.20	18.35
Gross Margin	11.54	5.85
Transportation & quality adjustment	1.05	5.75
Adjusted margin	10.49	5.10
Operating costs	3.50	2.50
Refining margin	6.99	2.60

N.B. The gross product value was calculated when gasoline prices were down 10 cents from their peak. If the highest price were used, it would increase the West Coast Refining Margin by over $2 a barrel.

Sources: Telerate product prices, DOE product yields, Chevron postings and West Texas Sour spot prices.

Senator METZENBAUM. Thank you very much.

Let me just say parenthetically to the Senator from Idaho, Senator McClure, you had talked about this chart, indicating that the Rotterdam market sort of proves the point that it was not the oil companies in this country who were raising the prices such an inordinate amount.

I would like to suggest to you we can look at the Rotterdam market and we will see it is pretty level until it gets to the time when Valdez occurs. And then when that occurs, you see it shoot way up.

I think what probably happened was the Rotterdam market probably followed the action of the American oil companies.

Senator MCCLURE. Would the Senator yield on that point?

Senator METZENBAUM. Sure.

Senator MCCLURE. Look also at the other chart that shows the great escalation of oil prices in the international market.

Senator METZENBAUM. The one right below that?

Senator MCCLURE. No, on page 19.

And you will note that the crude oil price, world crude oil price, went from a low of below $10.50 a barrel, a little over ten dollars a barrel, to a high of $18 a barrel in the period from mid-summer last year, early summer last year, until early this year.

Senator METZENBAUM. Yes, it moved back up. But then you find that it goes off the chart.

Senator MCCLURE. And I would also point out that this becomes more relevant to what happens in our markets. I am not arguing it explains it all. It may well not, but it is more relevant in our markets as our price, as our total mix of product in this country, becomes more and more dependent on imported oil.

Therefore, it has more impact than it would have had in a period of time when we were importing less. That may or may not have any relevance at all to the questions raised by the Controller with respect to California practices.

Senator METZENBAUM. Thank you.

Mr. Davis, I want to ask you. You make the statement that maybe the FTC and the Department of Justice ought to investigate and invoke the antitrust laws. This Senator has been Chairman of the Antitrust Subcommittee for a long time, and I am trying to tell you that I have difficulty finding a basis on which you can invoke the antitrust laws or for the FTC to act.

It may do something as far as consumer protection, but I do not know. That is the thing I referred to as oligopolistic when they all get together without actually getting together—it is easier to say—without coming, sitting in a room, and agreeing to do it.

But we do see in American industry that when one company does something and there are just a few competitors in that field, the others follow suit. We find it with respect to banks, we find it with respect to automobile manufacturers. We certainly find it with respect to oil company prices.

Tell me, if you will, where we can find an antitrust violation, unless it is in the activities of the pipelines?

Mr. DAVIS. I would be pleased to send you, Mr. Chairman, and the other Committee members copies of memoes that we have filed in our antitrust lawsuits against the major oil companies that show

collusion in their dealings with the independents, and also trading practices when they are transferring oil amongst themselves which indicate that they are actually valuing the oil much higher than the posted price.

And I would be pleased to bring that to your attention. I really think the Justice Department ought to join us in this lawsuit.

But more specifically, with regard to the recent price increase, I think it bears an explanation. You have heard this raised many, many times, but if it looks like a duck and walks like a duck it just might be a duck.

And we do have lower crude oil prices, we do have higher prices at the pump, and we do have some evidence of collusion. That would seem at a minimum, sir, to warrant an investigation and at least serious consideration of the applicability of antitrust laws.

Senator METZENBAUM. Is the Arco case still pending?

Mr. DAVIS. Arco is the only oil company that settled. They settled for $22.5 million. The other, the rest of the matter, is on appeal.

Senator METZENBAUM. You make some very strong charges in your statement. Can you actually document the charges that you make? Can you do so at this time?

Mr. DAVIS. I can, as I said before, provide the documentary evidence of higher prices oil companies are willing to pay for crude when they transfer it among themselves, higher than they are willing, than are reflected in the posted price.

And as you know, that means you and I, representing the state and Federal governments, are getting less than the full share of royalties that we deserve on our assets.

Senator METZENBAUM. I think——

Mr. DAVIS. Also, if I may, Mr. Chairman, I would like to ask, several attachments which I brought with me, which partially respond to your concern about documentation, be added to the record.

Senator METZENBAUM. Well, it depends. If it is that thick group of papers, I am not certain we are going to include all of that in the record. However, we will be glad to accept it from you and either it will be kept as part of the Committee records or we will make some determination as to how much of it will actually go into the record.*

Mr. DAVIS. Thank you, sir.

Senator METZENBAUM. I have several other questions, but it is getting very late and we have not heard from any witness other than Gray Davis.

Senator Johnston, do you have any questions?

The CHAIRMAN. Just one, and that is to tell Mr. Davis that I think your statement is very provocative, to say the least, and I think it is incumbent on us to find some of these facts that are not known.

There is only one conclusion, however, that seems curious to me, and that is that if we are concerned about monopoly power and about market power, concentration—and I am because I have seen independent refiners and independent producers go out of business

*The material has been retained in subcommittee files.

in this country at an alarming rate—but how does cutting down on domestic production encourage market power?

Because you say you want to—until you do away with monopoly power, you want to discourage drilling in this country. It seems to me it would be just the opposite conclusion. That is, the more domestic supply we have, the less chance for monopoly power there is, because real monopoly power, it seems to me, comes from importation, from the arrangements with OPEC, those kind of things, as opposed to domestic drillers, who are more likely to be independents, and more under domestic control.

Mr. DAVIS. Well, if I can respond in two or three ways, and I want to defer to your widely acknowledged expertise on this issue, Mr. Chairman. But just a couple points.

I think you know, Mr. Chairman, that the notion that we can be energy independent is a fiction. I have asked presidents of major oil companies to what extent we could reduce our dependence on foreign oil if we drilled every known resource in America, onshore and offshore, and the estimates range from one to three percent.

So we are going to be dependent on some source other than our own capabilities as a country.

Secondly, I think that it is a mistake to insist that we in California produce high-cost reserves when we are not getting the benefit of the royalties, for the reason I suggested earlier, and when there is really a hidden tax on Californians.

As you may know, EPA has required most of southern California to adopt stringent measures to deal with air pollution in southern California. The recent break the major oil companies got in reducing the environmental efficiencies that they have to achieve in offshore drilling will even worsen that situation in California.

So I think at a minimum we should not insist on drilling off California until we get a fair return on our assets. And you should not fool people into thinking it is going to make us energy independent, because it is a fiction.

The CHAIRMAN. Well, I understand that. But your answer would be, I guess, that drilling does not have anything to do with monopoly power, it does not encourage monopoly power, but you are concerned about other things, such as pollution and failure to get adequate dollars worth for the citizens of California?

Mr. DAVIS. If I could, Senator, I neglected to make the point that was most relevant to your question. The monopoly power lies in control over the pipelines on the West Coast, and even though your legislation requires that pipelines that cross over Federal lands be treated as common carriers, so that access is not denied to the independents and the price is also appropriately regulated, they are not treated as common carriers.

They are treated as private pipelines. There is only one pipeline that is treated as a common carrier and that is the Four Corners pipeline that Arco operates. Everything else is treated in a monopolistic fashion, and that is the stranglehold that the oil companies have on the West Coast, unlike situations in most of the rest of the country.

And that more than anything else I believe explains the difference between the low posted price and the high price consumers have to pay.

The CHAIRMAN. Well, those are some facts I think we need to get in this Committee, and we thank you for bringing those out.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Senator Johnston.

Senator MCCLURE. Mr. Chairman.

Senator METZENBAUM. Senator McClure.

Senator MCCLURE. Mr. Chairman, just a passing comment and then a question. The comment is, I am sure your one to three percent figure is with respect to proven reserves and not to current consumption based upon any finding of quantities of oil onshore and offshore, because certainly if ANWR produced in the way that Prudhoe Bay is, if we increased production onshore we would have a much larger impact upon domestic consumption than the one to three percent figure that you use.

But my question is, I assume that you have figures with respect to costs of refinery operation. Is there a difference between the costs of operating a refinery in California and operating a refinery in the Gulf Coast?

Mr. DAVIS. We have charts that are included in my documentary submission here that will explain that. But in general, the difference seems to be in the amount of profits that the oil companies are willing to——

Senator MCCLURE. Well, I know you had said that, but I wanted to focus for the moment on the relative costs of operation, because apparently you have done a great deal of work in this area and I would like to have the benefit of that work.

Mr. DAVIS. I think you will find your answers in the documents I am submitting.

Senator MCCLURE. Do you remember offhand what those differences are?

[Pause.]

Mr. DAVIS. The operating costs are $3.50 on the West Coast and $2.50 on the East Coast and Gulf Coast.

Senator MCCLURE. So it is a dollar a barrel difference in the refinery cost?

Mr. DAVIS. Right.

Senator METZENBAUM. I think Congressman Bates wanted to add something. Would you mind?

Mr. BATES. Just to simplify on this—and I would request that the Energy Information Agency report that brings to light this problem, it partially explains it, but not totally, and that is why more data is needed, and then the Chevron response, which also does not explain the full difference, so it is a partial explanation, but not significant to account for the full difference in the posted, the operating costs, and the final costs.

Senator MCCLURE. I think we are aware that the air pollution problems in southern California are the most severe in the nation, and that as a result there are more stringent requirements on operations, of which we are all aware.

Is there anything in the crude oil markets themselves that cause a difference in price? For example, Alaskan crude is carried first by pipeline and then by a U.S. tanker to the California markets.

Not all of the crude stops there. A portion of the crude goes on, and that is one of the things I am going to get into later, is trying

to find out what the current market is and exactly where that goes, so that the record may show what the distribution of the Alaskan crude is.

Does that change the crude oil market in California?

Senator METZENBAUM. I would like to say to the ranking member of this Committee that I am interested in this aspect of the exchange with Gray Davis, but I want to get into the Alaska Valdez situation. So if you could wind this up, I would appreciate it.

Senator MCCLURE. But he has done an awful lot of work, I take it, for the last 13 years or more in the Office of the Controller, and I am sure he has an opinion about how the petroleum markets in California differ from that in the Gulf Coast.

I thought, based upon his work, we could get a quick answer.

Mr. DAVIS. The short answer, Senator, is no, I do not think it explains the price differential. And even though, as we said before, the operating costs might explain a dollar of the difference, there is no marketplace explanation for a differential of $6.99 to $2.60.

Senator MCCLURE. I was not talking about the gasoline price. I was talking about the crude oil price, the crude oil market.

Mr. DAVIS. As I said in my opening testimony, even though the oil companies assert that there are marketplace explanations for the differential in crude oil prices, two staffers from the Department of Energy have recently rebutted that, and there is other documentary evidence that we can supply you to show you that the marketplace forces are not the explanation.

Senator MCCLURE. That is not included in that group of papers you are leaving with this Committee?

Mr. DAVIS. Yes, it is.

Senator MCCLURE. That information, the rebuttal there; and is their allegation also included there?

Mr. DAVIS. Yes.

Senator MCCLURE. So both their allegation and the rebuttal are included in those papers?

Mr. DAVIS. Yes.

Senator MCCLURE. Thank you vey much, Mr. Chairman.

Senator NICKLES. Mr. Chairman.

Senator METZENBAUM. Senator Nickles.

Senator NICKLES. I might ask, Mr. Davis, what is the posted price in California today?

[Pause.]

Mr. BATES. It is going up so fast.

Senator NICKLES. And how much—I might ask this question if you have to seek that. You mentioned that posted prices in California have been less than what they have been in other places across the country. How much less?

Mr. DAVIS. Excuse me, let me answer your first question. The crude price, I cannot tell you what it is today, but for the last month it has averaged about $17.20.

Senator NICKLES. For the last month it has averaged about $17.20? Well, a month ago in Oklahoma it was $17.75. Today it is $19.75.

I do not know that it is that much different than it is in California. Could it be, assuming that there is a difference, could it be

that a lot of California crude is a very thick, heavy crude and requires additional refining?

Mr. DAVIS. Again, that is an explanation that the oil companies would offer. But I think that has more to do with the additional operating cost of a dollar that Senator McClure mentioned earlier.

The differential between the posted crude price on the West Coast and the Gulf Coast has been apparent for a long, long time.

Senator NICKLES. How much is it?

Mr. DAVIS. Well, the statistics that I have available to me now, the differential was $17.20 on the West Coast to $18.35 on the Gulf Coast.

Senator NICKLES. Less than a dollar.

Mr. DAVIS. Slightly more than a dollar, $1.15.

Senator NICKLES. And could that be because—I mean, we have differences between West Texas crude and Oklahoma crude. I mean, there are different types of crude and different types of refining expense. There is liquid that can be extracted from different types of crude that sell maybe for a little more, a little less.

I just question some of your statements concerning the gouging and so on.

Mr. Chairman, I share your desire to move on to our next panelists. I may have some additional questions for this panel that I will submit in writing.

Senator STEVENS. Could I make one comment, Mr. Chairman?

Senator METZENBAUM. Certainly, Senator.

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Senator STEVENS. You know, Alaskans do not like the situation that Mr. Davis describes, but we understand it, I think. Alaskan oil tries to find a market in Washington, and then in Oregon, and then in California. If it does not find one in California, the next market is two dollars cost away.

So I think they sell it to whoever they can sell it to in California. Otherwise they have to pay that transportation cost down to Panama, it crosses through the Panama pipeline, and up to the East Coast. That is because it can only sold in the United States, do not forget.

And you all brought that on us. You all brought that on us. If you had a world market price, you would not have that dumping in California. It is dumped in California at lower cost because if you send it on it will cost two dollars more to sell it anywhere else.

Senator METZENBAUM. I want to go forward on this hearing. I appreciate having the Senator from Alaska with us, a former member of this Committee.

I appreciate hearing from you, Congressman. I appreciate hearing from you, Gray Davis. And we very well may wish to conduct some additional hearings as to the point that Senator Stevens just made, as well as to the point that you made previously with respect to these valuations in prices. And we may want to do that, either in this Committee or we may want to do it in the Antitrust Subcommittee.

But thank you very much for your participation.

Senator Cranston, we are very pleased that you saw fit to sit with us throughout this portion of the hearing. Thank you.

Our next witness is Henson Moore. Mr. Moore is the Deputy Secretary of the Department of Energy. I will say to you, Mr. Moore, we are delighted to have you with us and we are always happy to hear from the Energy Department, and I am looking forward, and I think every member of this Committee is, to working with Admiral Watkins.

But I wish you would bring to his attention, as well as all the other members of the Energy Department staff, that this Committee normally expects a witness' statement at least 24 hours before the hearing. It is my understanding we just received it a few minutes ago.

I cannot think of anybody who would be more knowledgeable in this area than you, in view of your past experience, and so you can understand where I am coming from on that comment.

We are delighted to have you and please proceed.

STATEMENT OF W. HENSON MOORE, DEPUTY SECRETARY, DEPARTMENT OF ENERGY

Mr. MOORE. Mr. Chairman, thank you. The fact that I am here this morning is testament to, when you contact the Department of Energy we try to work with you; we try to do anything we can to respond.

I apologize for the statement being late. Perhaps it was due to the shift and the lateness in who the witness might be.

I am pleased to appear before you to provide information on developments in the petroleum markets since the tragic Valdez oil spill of March 24th. The complete data for a thorough analysis of market responses to this event are not yet available. Nonetheless, there is some useful information that is available.

Within recent days, consumers in some areas of the country have seen a sharp increase in retail gasoline prices. Because these increases have come in the aftermath of the tragic *Exxon Valdez* oil spill in Alaska's Prince William Sound and the resulting disruption in oil shipments from Alaska, many consumers have begun questioning the adequacy of the Nation's supply of crude oil.

The Department of Energy intensified its monitoring of the availability of energy supplies and fuel prices immediately after the Valdez spill. Our analyses to date indicate that, while prices in many areas of the country, particularly along the West Coast, have risen to high levels, the supply of crude oil is stable. Any effects on the price of crude oil or gasoline directly attributable to the spill were at the most temporary. The interruption of tanker traffic in Prince William Sound lasted five days. The Alaska North Slope resumed full production of two million barrels per day on April 5th and is expected to maintain that production rate in the foreseeable future.

Furthermore, tanker shipments following the refloating of the Exxon Valdez on April 5th have returned to near-normal volume. As a result, the actual loss of Alaskan crude was approximately 13 million barrels of oil. This amount is small by national standards, about 17 hours of total national consumption. However, ten million

of the 13 million barrels were destined for West Coast refiners and the region suffered a disproportionate initial price impact, especially in the spot markets. In the two weeks following the spill, West Coast crude oil losses were offset by crude oil from other producing regions, by drawdown of refinery crude oil stocks, and by product imports. However, the interruption of Alaskan crude in the minds of some people created serious concern or fear for future supply curtailments in the product markets. This concern, more than actual supply curtailments, could have had an effect on price increases. Now, three weeks after the spill, other crude supplies and overshipment of crude accumulated at the Valdez terminal have nearly compensated for the earlier loss of supply. Therefore, we conclude that the actual loss of 13 million barrels had no lasting or permanent effect on gasoline prices.

Senator METZENBAUM. Would you repeat that, please?

Mr. MOORE. I thought you might ask.

Therefore, we conclude that the actual loss of 13 million barrels of oil had no lasting or permanent effect on gasoline prices.

Observed wholesale price increases, which began in January, long before the spill, can be attributed to several causes. Crude oil prices (West Texas Intermediate crude) rose from a two-year low of $12.58 per barrel in early October of 1988 to slightly above $20 per barrel by March 23, 1989, the day before the Valdez incident. This price increase of $7.50 per barrel translates into an equivalent increase in product prices of 18 cents per gallon. However, both average U.S. wholesale and retail prices of gasoline lagged the crude oil price increase by some four months. Wholesale price increases due to the crude oil price increases had begun to appear before the Valdez incident. Average U.S. gasoline retail prices, for the Nation at large, however, had remained essentially unchanged over the period early October 1988 to mid-March of 1989. Other factors may also have contributed to the rise in gasoline prices since February. These factors include strong seasonal gasoline demand, lower refinery gasoline inventories due to routine seasonal refinery maintenance, and new gasoline specifications that reduce vapor emissions, but increase refining costs. A thorough analysis of the extent to which these other factors contributed to the observed retail price increases is not yet available.

Fortunately, supplies are not threatened. Shortages have not occurred. Prices in California have fallen from their reported peaks. By April 14, spot gasoline prices had fallen by 36 cents per gallon. Market forces are operating to provide California markets with energy, albeit at higher prices, following the brief interruption of Alaskan crude oil.

The worst consequences of the Valdez spill will be environmental, not gasoline price increases.

I thank you for the opportunity to present the Department of Energy's perspective. I would be pleased to answer your questions.

[The prepared statement of Mr. Moore follows:]

STATEMENT OF

W. HENSON MOORE

DEPUTY SECRETARY

U.S. DEPARTMENT OF ENERGY

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

U.S. SENATE

APRIL 17, 1989

Statement of
W. Henson Moore
Deputy Secretary
U.S. Department of Energy
Before the
Committee on Energy and Natural Resources
Subcommittee on Energy Regulation and Conservation
U.S. Senate
April 17, 1989

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The interruption of tanker traffic in Prince William Sound lasted 5 days. The Alaska North Slope resumed full production of 2 million barrels per day on April 5 and is expected to maintain that production rate in the foreseeable future. Furthermore, tanker shipments, following the refloating of the Exxon Valdez on April 5, has returned to near normal volume. As a result, the actual loss of Alaskan crude oil was approximately 13 million barrels. This amount is small by national standards, about 17 hours of total national consumption. However, 10 million of the 13 million barrels were destined for West Coast refiners and the region suffered a disproportionate initial price impact especially in the spot markets. In the two weeks following the spill, West Coast crude oil losses were offset by crude oil from other producing regions, by drawdown of refinery crude oil stocks, and by product imports. However, the interruption of Alaskan crude, in the minds of some people, created serious concern or fear for future supply curtailments in product markets. This concern, more than actual supply curtailments, could have had an effect on price increases. Now, three weeks after the spill, other crude supplies and overshipment of crude accumulated at the Valdez terminal have nearly compensated for the earlier loss of supply. Therefore, we conclude that the actual loss of 13 million barrels had no lasting or permanent effect on gasoline prices.

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in product prices of 18 cents per gallon. However, both average U.S. wholesale and retail prices of gasoline lagged the crude oil price increase by some four months. Wholesale price increases due to the crude oil price increases had begun to appear before the Valdez incident. Average U.S. gasoline retail prices, for the nation at large, however, had remained essentially unchanged over the period early October 1988 to mid-March of 1989. Other factors may also have contributed to the rise in gasoline prices since February. These factors include: strong seasonal gasoline demand, lower refinery gasoline inventories due to routine seasonal refinery maintenance, and new gasoline specifications that reduce vapor emissions but increase refining costs. A thorough analysis of the extent to which these other factors contributed to the observed retail price increases is not yet available.

Fortunately, supplies are not threatened. Shortages have not occurred. Prices in California have fallen from their reported peaks. By April 14, spot gasoline prices had fallen by $0.36 per gallon. Market forces are operating to provide California markets with energy, albeit at higher prices, following the brief interruption of Alaskan crude oil.

The worst consequences of the Valdez spill will be environmental, not gasoline price increases.

Thank you for the opportunity to present the Department of Energy's perspective. I will be pleased to answer any questions at this time.

Senator METZENBAUM. Thank you very much.

The Chair will institute a five minute rule of questions for the first round for each member of the Committee.

Mr. Moore, why did gasoline prices go up so much in Ohio, the South, and the East after the *Exxon Valdez* spill, even though these states' supplies do not depend on Alaskan crude oil or California refineries?

Mr. MOORE. Mr. Chairman, we can give you, through figures compiled by the EIA, a detailed analysis of each of the States you have just mentioned.

[Subsequent to the hearing DOE supplied the following:]

EIA's analysis indicates that, on an annual basis, the difference in the prices of motor gasoline between regions is less than 5 percent of the national average. For example, refiner wholesale prices at the regional level (Petroleum Administration for Defense Districts or PADD's) in 1987 ranged from 55.1 cents in the South-Central States to 61.3 cents on the West Coast, including Alaska and Hawaii. Differences in the prevailing price levels for motor gasoline between and within these regions are largely a function of the cost and availability of supply.

- The cost of the delivered product is dependent on the proximity of the market to refining centers and, in turn, to crude production itself. It costs approximately 2.5 to 3.5 cents per gallon to deliver finished motor gasoline to New England from Caribbean or Gulf Coast refineries, respectively. The price of moving crude oil and/or motor gasoline from the Gulf Coast into the Chicago area is about 2.0 cents per gallon.

- To a lesser extent, refining costs vary depending on the quality of the crude to be refined and the environmental specifications of the States in the regional market. Heavy crude oils in California, for example, require extra processing, and volatility standards there have been among the strictest in the country.

Over the course of a year, demand varies among the regions and price differences get larger or smaller depending, in large part, on how the supply system responds.

- Regions that have to "import" finished motor gasoline from other regions or from foreign sources to meet increases in demand must bid up the price sufficiently to meet or exceed the cost of gasoline in those alternative markets plus the transportation cost. New England, in particular, is dependent on imports of foreign gasoline and, as a result, is more directly affected by world market conditions. Constraints in the infrastructure system (e.g., pipeline and terminal capacity) require alternatives that add further to the cost and, hence, the price needed to increase available supply in a given region.

- Demand may vary among regions even apart from the timing of the summer driving season. In February 1989, demand for finished motor gasoline (as measured by first sales of suppliers reported to the Energy Information Administration) increased twice as much in the Midwest (PADD II) as it did on either the East or West Coasts. This surge in demand (and expectations that it would continue) generated upward pressure on prices in early March, first in wholesale and then in retail markets.

In addition to these market factors, there are differences imposed by the States themselves that directly affect prices at the pump. These include difference in tax rates and local regulatory restrictions (e.g., the District of Columbia regulation requiring vapor canisters on the pumps for butane emissions).

Regional and State price trend graphs prepared by EIA follow (Figures 3-10).

FIGURE 3

GULF COAST PETROLEUM PRICES

UNLEADED GASOLINE PLUS ANS AND WTI CRUDE

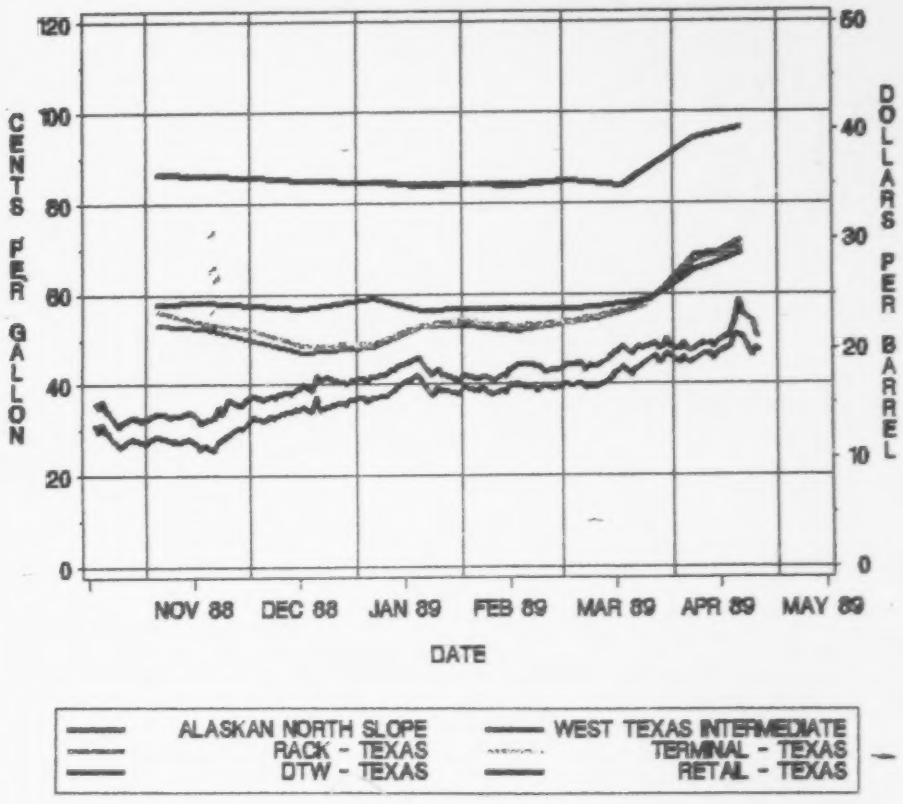


FIGURE 4

INDIANA PETROLEUM PRICES

UNLEADED GASOLINE AND WTI CRUDE

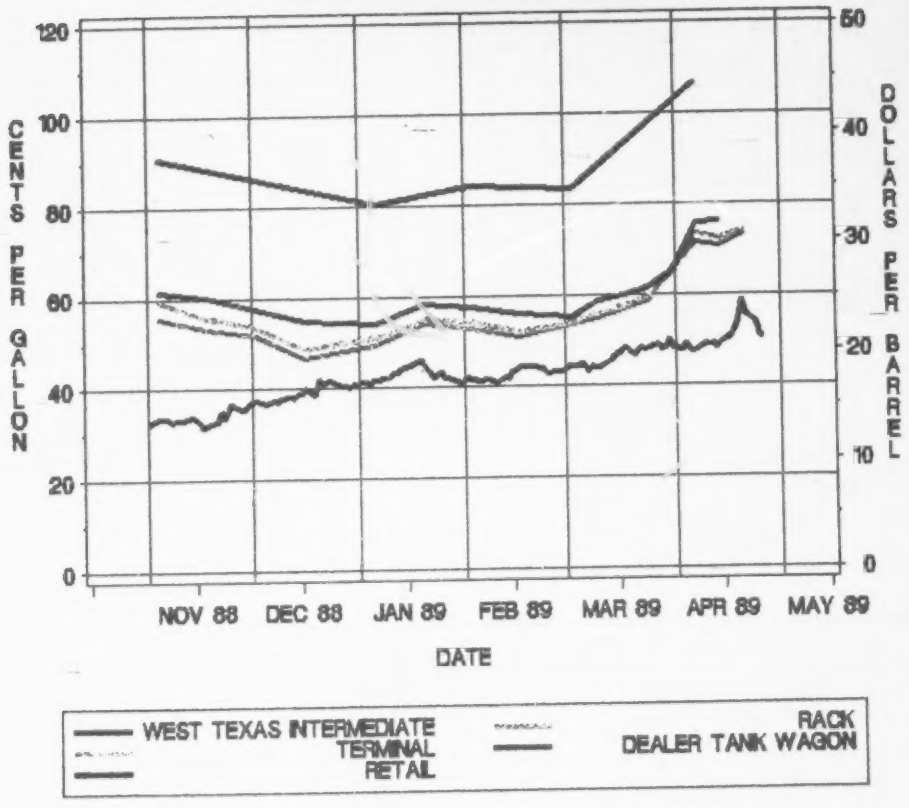


FIGURE 5

OHIO PETROLEUM PRICES

UNLEADED GASOLINE AND WTI CRUDE

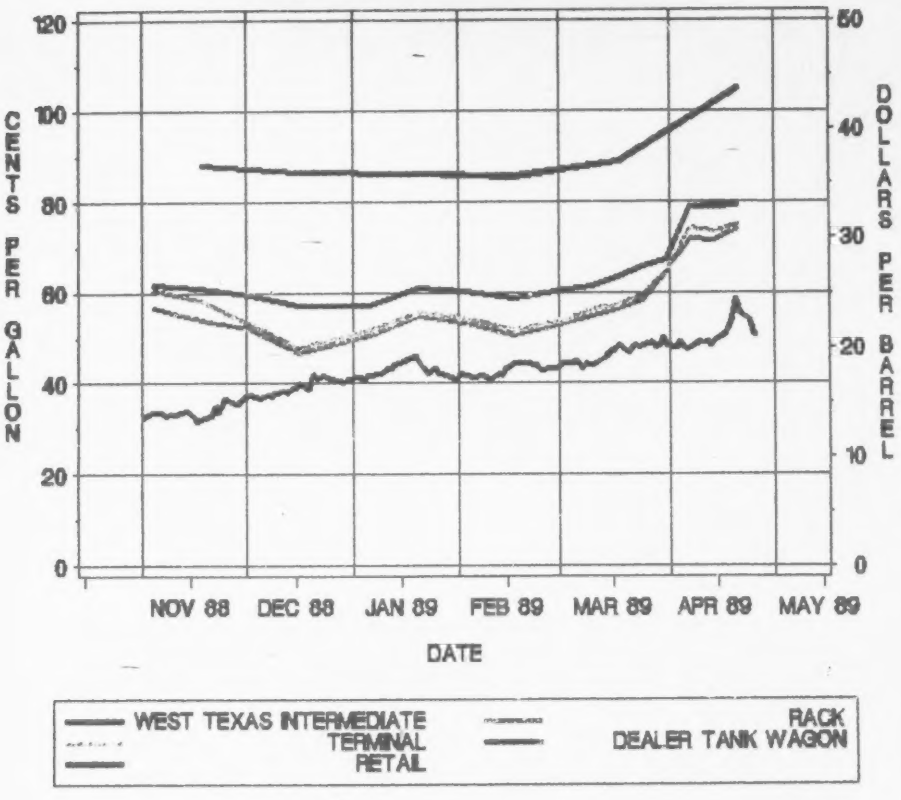


FIGURE 6

ILLINOIS PETROLEUM PRICES

UNLEADED GASOLINE AND WTI CRUDE

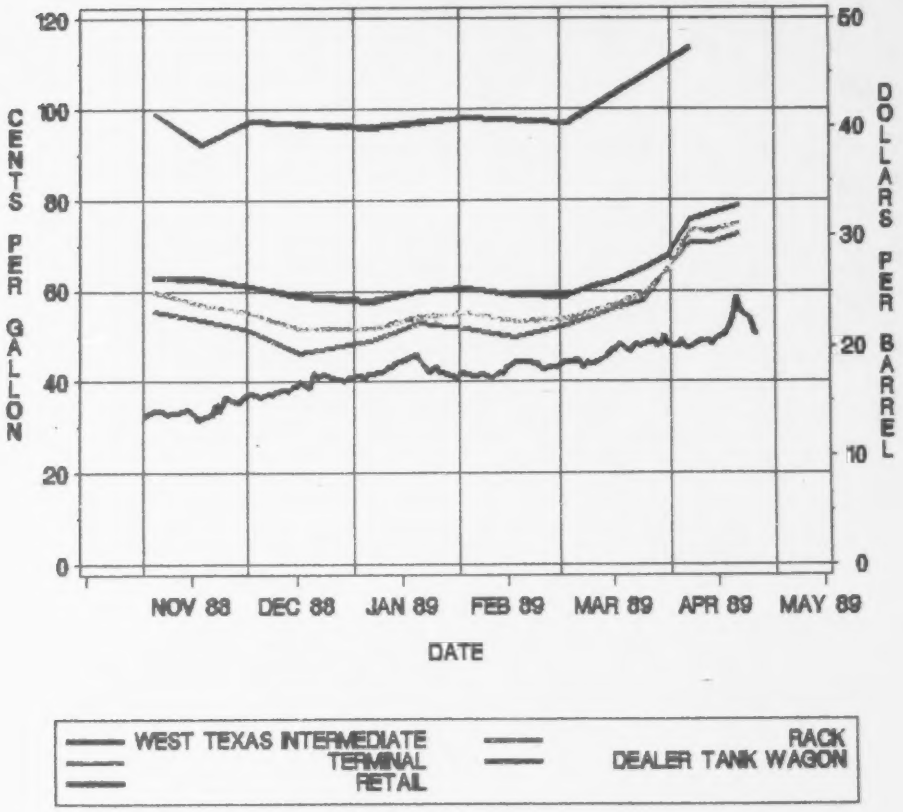


FIGURE 7
MICHIGAN PETROLEUM PRICES
UNLEADED GASOLINE AND WTI CRUDE

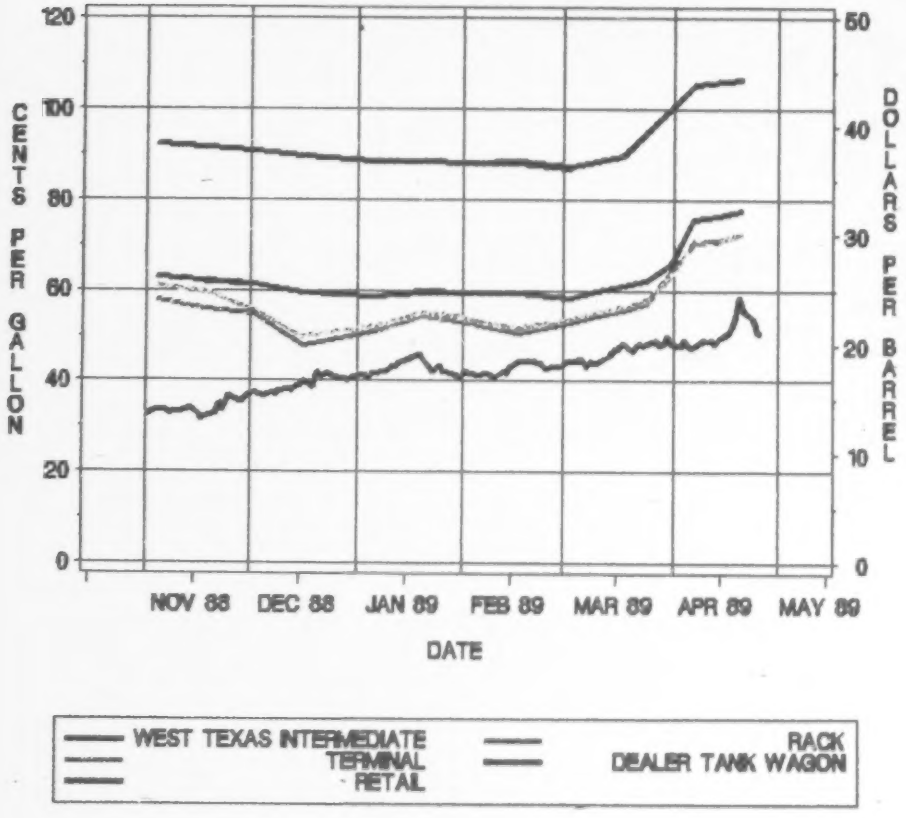


FIGURE 8

NEW YORK PETROLEUM PRICES

UNLEADED GASOLINE AND WTI CRUDE

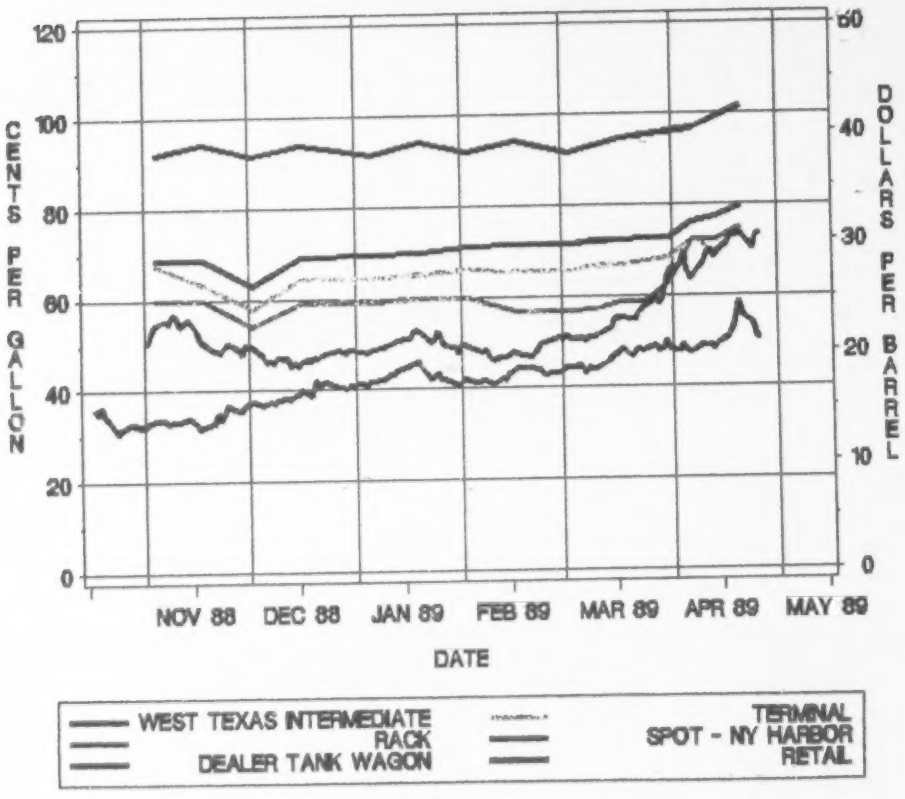


FIGURE 9
WEST COAST PETROLEUM PRICES
UNLEADED GASOLINE AND ANS CRUDE

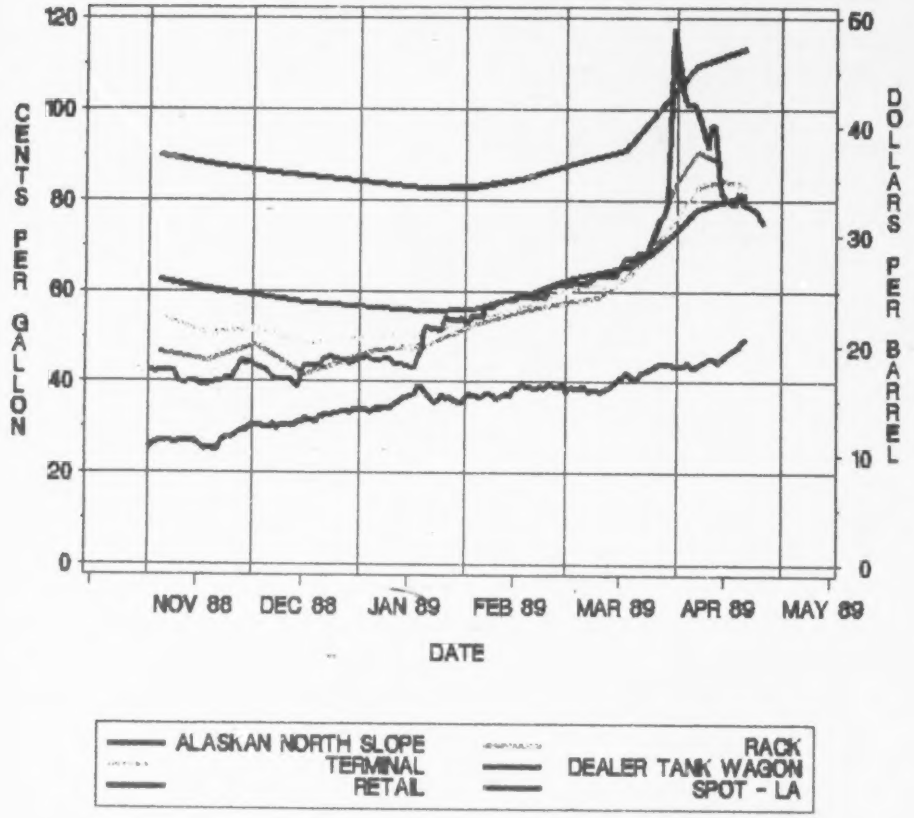
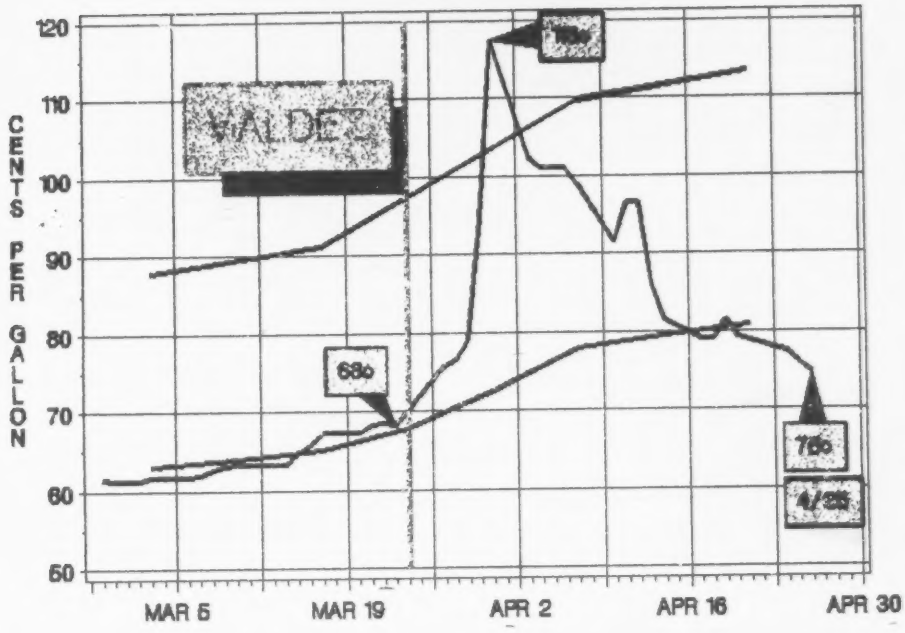


FIGURE 10
CALIFORNIA GASOLINE PRICES
UNLEADED REGULAR



Mr. MOORE. Suffice it to say the only justification we can measure at this point is that the increase of crude oil prices, which occurred across the market internationally, as well as West Texas Intermediate crude, had not worked its way through the system; and it began working its way through the system in the wholesale markets in January. That is still occurring as we speak perhaps.

Senator METZENBAUM. Are you suggesting that it is just happenstance that the Valdez incident occurred and that at that very moment these other factors with respect to increased costs of crude triggered into place and the word went out across the country, increase prices 10, 20, or 30 cents a gallon?

Do you think that that really happened? Or do you not think that there was an exploitation of the situation?

Mr. MOORE. Mr. Chairman, we cannot answer those kinds of questions until we complete the analysis. All we do know is in January of this year the wholesale price increases began, long before the Valdez spill. Those wholesale prices were not felt at the market pump, or at the retail pump, until later.

Senator METZENBAUM. I have a chart here and you see it over there, and you will notice that on March 22nd the price was about $20, and you notice that on April 13th the crude oil price was maybe $20.20 or 30 cents, I am not sure. But the fact is that at the pump the unleaded gasoline price rose from about 24 dollars per barrel on March 22nd to about $29 per barrel.

Mr. MOORE. Senator, I think your chart may be correct from the point of view of the dates it has on it. We are going back further in time, back to October 1988, to give a more complete chart.

If you do that—we have a copy here—you will find that the retail prices were level up until the dates that you show on your chart. Meanwhile, the crude oil prices had been rising and then began to level off on the dates shown on your chart.

So I think your chart is accurate from the time it shows. It just needs to show an earlier time period.

Senator MCCLURE. Would you yield for one question, so I may understand your chart?

Senator METZENBAUM. On your time.

Senator MCCLURE. It says "crude oil WTI." Is that "West Texas Intermediate"?

Mr. MOORE. Yes.

Senator MCCLURE. Which is one oil out of dozens of oils that enter the market.

Senator METZENBAUM. Well, I am sure the Senator knows that there is no sense in just taking a whole grouping of them. You have got to take one. We took West Texas Intermediate because it is regarded as the benchmark U.S. crude.

Mr. MOORE. Mr. Chairman, I am also informed, by staff of the EIA with me this morning, that they believe that your red line, "unleaded gasoline," is the spot market, and that reacted more volatilely than did the normal retail market. It went up much faster and likewise came down much faster.

Senator METZENBAUM. I think you are correct that it is the spot market, but it is irrefutable that the retail price just zoomed immediately after the Valdez incident.

And that is the thing that I think is somewhat disturbing to this Senator, that the Department of Energy did not take any steps to calm the panic, dampen the price hikes. And the Secretary's statement the other day framed the issue as one "of the adequacy of the nation's supply of crude oil."

Now, I think the evidence is very clear that there has not been a problem with respect to supply. There is no problem now. Prices have not receded. And I think what is concerning me is the failure of the Department of Energy to take any action or to speak out in connection with this problem, because the American consumer is obviously very upset.

You would not have had more than ten Senators here this morning if that were not the case. Now, in fairness, not all of them take the same position. But the fact is that there is tremendous rumbling out there. The American people think they are getting ripped off, and some of us, including me, think they are getting ripped off also, and we think that the oil companies are exploiting the situation.

What bothers me is that the Energy Department has not seen fit to speak out or to indicate any concern about consumer prices.

Mr. MOORE. Senator, we did. In fact, the Admiral did speak out with press releases and statements to the press indicating that there was no evidence of any supply disruption whatsoever and that there was no need to even talk to the President about using the Strategic Petroleum Reserve oil supply, that that was really not a problem.

The fact that prices on the spot market behaved very erratically, that is something we cannot answer, other than perhaps the psychology of that particular market.

Senator METZENBAUM. Does the Department of Energy have any recommendations to prevent drastic price flyups in the future, and do you have any thoughts on that at all, Mr. Moore?

Mr. MOORE. First of all, certainly, we need to do everything we can to be sure that all the data that is being collected can be, so that we can respond, as you are suggesting, to the market and to the public about what we see and what we are able to measure.

The problem is by the time the data comes to us the volatility has already occurred. It will be the end of this month before we have all the figures to really analyze why that market, the spot market, reacted so erratically in California.

That being the case, it is past that time. The market has already come down. That market has already receded 36 cents a gallon for gasoline out there.

So we will try to do the best we can to be more responsive with the information we have. The problem is that information is usually late getting to us.

And secondly, I would just hope that in the future when gasoline prices go up, if there is a good reason for it, that is explained to the public by those that are raising their prices; that from what we see there is an 18 cent per gasoline cost increase that could be determined as justified based upon the price, the price in that same time period, of crude oil. That should have been revealed to the public. That should have been stated by those raising the prices, and it would be helpful if they would do that in the future.

Senator METZENBAUM. Mr. Moore, when you were a member of Congress, on August 15th, 1985, you wrote this letter asking Helmut Merklein, the Energy Information Administrator, to improve the quality of data collected by DOE on domestically produced oil, just the same as we collect on foreign oil.

Have you had an opportunity—did you ever get an answer to that? And since you have become a member of the Department of Energy, have you had any answer? Have you had an opportunity to pursue that further with Dr. Merklein?

Mr. MOORE. I do not remember the answer received in 1985 or while I was in Congress. We did discuss it this morning, with Dr. Merklein, as to why that has not been done; and what are the chances of it being done.

I think we are more than willing to have EIA sit down with your staff or the staff of the full Committee or Congressman Bates or anyone else who has an interest, to really thrash through that.

It has been looked at by, as I understand, the General Accounting Office. It has been looked at by others, and we are more than willing to have it looked at again to see if there is some way to do that.

I have sympathy for the questions that were raised this morning by the Controller and by the Congressman. That is what prompted me to sign that letter along with the Chairman of the full Committee back in 1985.

Senator METZENBAUM. We would look forward to working promptly with you in getting the EIA Administrator to find out why we cannot get full information, and get it much more rapidly.

The Chair is really not certain whether in a Subcommittee the ranking Chairman of the overall Committee or the ranking member of the Subcommittee has priority.

The CHAIRMAN. I think the ranking member does.

Senator METZENBAUM. All right. Senator Nickles, happy to hear from you, sir.

Senator NICKLES. Mr. Chairman, thank you very much.

Mr. Secretary, just looking at some of the prices that I have been trying to chase down for this hearing, on West Texas Intermediate you mentioned that the chart that we are looking at does not go back far enough. Would you provide for the Committee a chart that would go back to October, for our information?

The information I have before me shows that posted prices—now, that is New York spot, which is more volatile than posted. But I show posted prices on October 20th, West Texas Intermediate, at $12.75. I also remember—or correct me if I am incorrect, but OPEC had a meeting in November or December where basically they stated a goal to raise the prices into the $18 to $20 range. They have been quite successful.

I have noted a fairly continuous increase in West Texas Intermediate. In November it was $13.75, on February 17th it was $17.25, on March the 15th it was $18.50, and March 23rd, the day before the tanker spill, it was $19. So we have had a six dollar increase in a period of four and a half, five months, which was, that six dollar increase, was almost 50 percent, 45 percent.

I think that is of interest. Today West Texas Intermediate posted in my state is $19.75. So it has continued to escalate.

But really what we are looking at is increases that have been caused by OPEC in a manipulated, designed, charted move from their last meeting, is that not correct?

Mr. MOORE. That certainly had an impact on it, Senator. We can furnish you that chart that you were asking for. As a matter of fact, it has already been prepared.

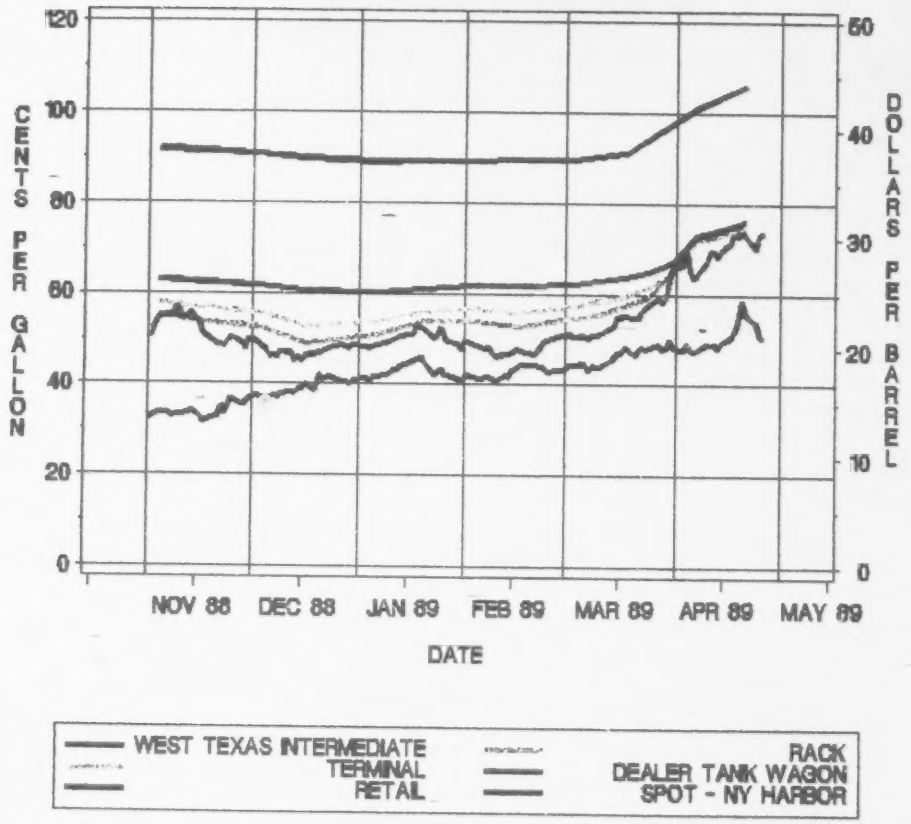
[The information follows:]

The chart (prepared by EIA) contrasting price trends in unleaded gasoline and West Texas Intermediate crude oil covers the earlier period from Fall 1988 (not shown on the Committee's original graph) through the latter half of April. (See Figure 2.)

FIGURE 2

US PETROLEUM PRICES

UNLEADED GASOLINE AND WTI CRUDE



Mr. MOORE. We can also try to furnish you an analysis by EIA about what the various factors were that caused that increase in the price of crude. One of them was certainly the actions of OPEC.

[The information follows:]

Prior to the oilspill caused by the *Exxon Valdez,* crude oil prices had been rising for several months. Between the recent low of $12.58 per barrel in October of 1988 and March 23, 1989 (the day before the Valdez spill), crude oil prices (West Texas Intermediate, WTI) increased by about $7.50 per barrel. EIA's analysis indicates that the increase was caused by several factors, including:

A new official OPEC production quota reached in November of 1988 which limits production to 18.5 million barrels per day beginning in 1989.

An agreement in February by several non-OPEC producers to limit production by as much as 300,000 barrels per day.

Strong demand for oil in the fourth quarter of 1988 resulting in only normal stock levels in OECD countries, instead of the high or excess stocks originally expected due to large increases in OPEC production prior to new quota agreement.

Initial signs that oil demand in the first quarter of 1989 remained strong.

Continued problems with production from the North Sea.

Senator NICKLES. Well, I would appreciate it if you would supply that, because I think it is important when you get into these issues to have the facts and to have the facts before us so we can make decisions.

I will be frank. I was surprised to learn that there had been that sudden a rise in posted prices, and I probably follow the posted prices closer than most anyone up here, because it certainly affects the economy of my state.

And I understand the Controller's concern on gross production taxes and so on, but I find it almost ironic that they were complaining about the low prices for posted crude in California, and I think Senator Stevens and others—there are some reasons for that.

But I appreciate your statement before the Committee. Would you think that, when you are talking about spot market prices and particularly with the concerns—our staff gave us information that said that about 70 percent of Alaska oil finds its way to market in the West Coast. Is that close, the West Coast including Hawaii?

Mr. MOORE. Yes, Senator.

Senator NICKLES. So you could have somewhat of a panic or a scare or a remembrance of the 1973 and 1979 shortages that certainly would play on spot market prices, and also the speculators' involvement with that, that sensitivity to it, plus the fact that the media was giving a great deal of attention to the spill and that might have hyped it to some extent and you have seen the market really react.

Did I hear you say that the prices have declined 36 cents in the last couple of weeks? Is that correct?

Mr. MOORE. The spot market, yes, Senator.

Senator NICKLES. But again, we are talking about spot, which is much more speculative and not so much reality, is that correct?

Mr. MOORE. The spot market is what is referred to as a thinner market. It is a smaller market. It tends to be more volatile. It was in this case more volatile. It moved up very quickly. We do not know why yet. We will get the data and look at it. At this point there is conjecture or thought at EIA that it had something to do with the psychology of being fearful that—at one point I think the Governor of Alaska made a comment that, if something is not done, you are going to have to shut off the supply of oil from

Alaska. And it was about that same time period that we saw that kind of volatility.

It has now abated. It has come down 36 cents a gallon on the spot market, leaving you with a retail price increase which is less than that.

Senator NICKLES. Do you happen to know offhand how much oil California produces?

Senator METZENBAUM. Could I just clarify something? Do you mean it came down 36 cents a gallon or 36 cents a barrel?

Mr. MOORE. Let me doublecheck.

We have here, spot gasoline price has fallen by 36 cents a gallon, spot gasoline prices now.

Senator METZENBAUM. From what to what?

Mr. MOORE. By April 14th.

Senator METZENBAUM. Are you talking about retail prices?

Mr. MOORE. No, we are talking about spot gasoline prices.

Senator NICKLES. The point I am trying to make, Mr. Chairman, I made it in my statement, is that when you use the spot prices you are using a much more inflated, volatile, speculative, in many cases almost hyped-up—in this case, for instance, you had a fear psychology running through for a period of time, and it is not as close to reality as using actual prices that consumers pay.

And certainly, if there has been a 36 cent drop per gallon in spot market prices, that shows that it was greatly inflated and also has deflated as well.

Senator METZENBAUM. But it strains credulity, this representation, because I do not know of any place in the country where there were any reports that gallon at the pump has come down anything like that. In fact, it continues to go up.

Mr. MOORE. The retail prices in California, Senator, have been on an incline, a steady incline. The spot market rose very erratically, as shown by your chart, and then it came down almost as erratically.

Now, the retail prices at the pump are still higher than they were before the Valdez incident, and we think this could be reflecting—and we think figures will show that over time—at least in part due to the crude oil price increases, which would translate to some 18 cents a gallon, which had not been reflected at the pump in California up to some point prior to Valdez.

Senator NICKLES. The final question, Mr. Chairman, I have: You mentioned the crude oil prices being the underlying cause and that they have increased dramatically since October through April. Again that was caused, not by Valdez, but that was caused by a meeting of the OPEC ministers and stating their goal to somewhat reduce production in order to escalate prices, is that correct?

Mr. MOORE. It certainly played a major factor in it, Senator.

Senator NICKLES. Thank you very much, Mr. Secretary.

Senator METZENBAUM. Thank you.

Senator JOHNSTON.

The CHAIRMAN. Secretary Moore, should prices come down in the next few week? Or to ask the question another way, are margins now for either marketers or refiners higher than usual?

[Pause.]

Mr. MOORE. Margins were good in January and February and are coming down, I am told by EIA. But we cannot give you the figure now. We do not have that data yet. We do not know what the margins are now, or even in March.

The CHAIRMAN. Are those ascertainable?

Mr. MOORE. They will be when we have the data come in. I do not think we can do it today or tomorrow.

The CHAIRMAN. There is a time lag?

Mr. MOORE. That is right, before we can actually collect the data, assimilate it, and then go through it and draw an analysis from it. That is what I was saying a moment ago. It is hard for us to give in today's testimony anything more than we are able to do because we do not have the data. And even when we do get it, it takes time to analyze it. We could not do that for prices that just occurred last week. We cannot do it that quickly.

The CHAIRMAN. Right.

Gray Davis, the Controller of California, talked about the market power of major oil companies. He said that, with respect to West Texas Crude, they pay less for their crude and yet they charge more for their gasoline. And he says the reason is that refiners have three times the per-barrel margin versus the Gulf Coast, for example.

He says the reason they are able to do that is because of the market power and control over the transportation system, particularly the pipeline system. Do you have a judgment on that?

Mr. MOORE. Senator, we do not. I listened to the charge. It is certainly a very grave one and it is worthy of being looked at by the Federal Trade Commission and the Justice Department if the evidence is there, and, certainly, we shall take a look at that or try to make some sort of analysis of it.

But I have no feel for it now.

The CHAIRMAN. Can you give us a report on that? Can you give us a judgment as to how long it would take to get a report on that?

[Pause.]

Mr. MOORE. Senator, the answer is we can give you an overview of the pipeline situation, they are saying, within a month to two months. We will see if we can do better than that.

The CHAIRMAN. All right, if you could give us a preliminary report as soon as you can, because this is a charge that not only is a serious charge, but it is a very important issue for millions of Californians and all Americans, I am sure.

So if you could give us a quick overview as quickly as you can, and then maybe an intermediate report and a final report, that would be helpful to us.

[The information follows:]

The California crude oil pipeline transportation system primarily is a proprietary system owned by a small number of companies. Only one of the pipelines is federally regulated and operates as a common carrier. The following is a brief overview of the crude oil pipeline system.

Pipelines operate primarily from the San Joaquin Valley production area to the refinery areas of San Francisco, Los Angeles, and the Coastal are of the State. From San Joaquin Valley to San Francisco three pipelines operate owned by Chevron, Texaco, and Unocal. From San Joaquin Valley to Los Angeles two pipelines operate owned by Mobil and Four Corners, a federally regulated common carrier owned by Atlantic Richfield. From San Joaquin Valley to the Coastal area two pipelines oper-

ate owned by Chevron and Unocal. Finally, two pipelines operate from Ventura to Los Angeles owned by Shell and Texaco. All of these pipelines except Four Corners are proprietary pipelines and are not operated as common carriers.

The issue of alleged anticompetitive behavior by the major oil companies in this market is currently being litigated in a case entitled *State of California, et al.,* v. *Chevron Corporation, et al.,* in which the Ninth Cirucit Court of Appeals recently reversed a summary judgment that had been entered in favor of the defendant oil companies and remanded the issue for trial. The Department has received requests to produce data from both the plaintiffs and the defendants in this litigation and is cooperating with those requests. Since it would be inappropriate for the Department to take a side, or to take action that could be perceived as taking a side, in an ongoing case to which the Federal Government is not a party, and since the evidence that will be developed and court findings that will be made in this case are likely to resolve many, if not all, of the questions that have been raised regarding alleged anomalies in the California market, the Department believes that any more detailed analysis than those it has made to date would be inappropriate at this time.

The CHAIRMAN. Secretary Moore, I have noticed regional disparities in price sometimes as high as 15 cents a gallon. Gasoline seems to be cheaper in my own state than in Virginia.

Do you have an explanation as to why that is, why there are such large regional disparities in the price of gasoline?

Mr. MOORE. We have prepared and do have available on analyses for each—or some of the various States and regions of the country, looking back from October to the present, on what has happened to retail prices and spot prices for gasoline.

An analysis of why that has happened in those States is something I cannot answer now. It is something we ought to try to answer and we can prepare for you.

The CHAIRMAN. Well, I have been concerned for some time about the number of competitors who are going out of business. Refiners, we used to have so many more independent refiners and independent marketers. They are really becoming an endangered species.

Of course, the producers are also going out. It seems to me there are more producers than there are refiners and marketers. It seems to me we need some sort of analysis of that, about the lack of competition in marketing and refining.

Do you have a judgment on that?

Mr. MOORE. No judgment now until we get the study done that you are asking for, and staff is indicating we can do that and we will do that.

The CHAIRMAN. I think the problem is exacerbated by the increase of imports. If the production sector is more competitive, as I think it is, than is refining and marketing, then the move to import more, particularly to import from OPEC countries, exacerbates the problem of market power and market control.

I think it is really a serious problem. I mean, when you look at the change in the structure of the industry from just the last ten years, I think it could be a real cause for alarm, and I think the Energy Department ought to take a look at it.

Can you do that and give us a report on that?

Mr. MOORE. We will.

[The information follows:]

An EIA analysis of the degree of competition in the petroleum marketing and refining industry and the impact of increased imports follows:

> To address the nature of competition in an industry, two general characteristics are examined: structure and performance. A key structural issue involves seller concentration. Over the past decade, the refining sector has had to respond to a range of changing market conditions: crude price instability; until recently, shrinking product demand; changing environmental regulations; and the need to upgrade gasoline production capability even as the quality of crude oil raw material declined. During this period, many firms have exited the industry and considerable reductions in crude distillation capacity (a reduction of 3.2 million barrels per day between 1981 and 1986) occurred. Nonetheless, concentration has remained at relatively moderate

levels with only slight increases registered during the 1980s (Table 1). Thus, despite relatively slow growth of the industry, there is no strong tendency toward increased concentration.

Performance of an industry reflects the degree to which industry prices, profitability, and investment approximate the results which would be expected from a purely competitive market. Although the U.S. refining industry has been eliminating excess distillation capacity, refiners have undertaken substantial investments in order to upgrade the remaining capacity. For example, the major petroleum companies reporting to the Energy Information Administration's Financial Reporting System had capital expenditures for U.S. refining operations which totaled over $17 billion, largely for upgrading, over the 1981 through 1985 period. These expenditures equalled their 1981 investment base in U.S. refining and occurred during the period of greatest capacity reduction.

In the U.S. refining industry, product prices reflect the movements in crude oil prices, the major refining cost component, but with a lag. As a consequence, refiners' margins tend to rise in periods of declining crude oil prices and tend to decline in periods of rising crude oil prices.

Since 1978, refiners' margins reflect three major trends (Figure 1). From 1978 through 1981, Federal price controls dominated the determination of refiners' margins. Over this period, margins were gradually increasing. From 1981 (when price controls were lifted) to 1984-1985, the trend in refiners' margins was one of gradual decline as the industry was characterized by over-capacity and much of this excess capacity was retired. Since 1985 demand has been increasing in response to low prices and refinery utilization has been steadily increasing, causing a gradual improvement in refiners' margins. Overlaying these general trends are seasonal variations in margins. These are generally quite regular and can easily amount to 10 cents per gallon.

The course of refiners' profitability closely tracks the movements in margins (Figure 2). Until recently, the profitability of U.S. refining operations has been below that of industry generally. As Figure 3 shows, among the majors, the return on investment for these operations has been below their overall return on investment during most of this decade. As shown in Figure 4, the return on equity (a commonly used measure of corporate profitability) of the majors has been below that of other industrial corporations in recent years. Similarly, as shown in Figure 5, the return on equity for non-major refiners achieved parity with other

industrial corporations only in the latter part of 1988 during the period of relatively high margins.

Between 1978 and 1986, retail margins (as distinct from those for refining) increased gradually (Figure 1). Much of this increase was likely due to increases in Federal and State gasoline taxes which are included in the margin. Since 1986, retail margins have not shown any tendency to increase as retail and wholesale gasoline prices have moved in a more or less parallel pattern.

Based on performance, the U.S. refining sector appears to operate in an essentially competitive mode. Prices are responsive to demand and costs, subnormal profitability is slowly being eliminated, and investment has responded to changing conditions in product markets and raw material markets.

Companies engaged in petroleum refining also engage in direct marketing of refined petroleum products. In most cases, however, forward integration is only partial. Aside from gasoline, most refined products are sold to wholesale resellers who serve the chain of retail distribution for these products. With respect to gasoline, the majors market about one-half of their production directly through company

owned outlets and through branded lessee dealers. The other half is sold to wholesale resellers. Though nationwide the number of gasoline stations has declined substantially over the last decade, channels of distribution have changed little. The degree of integration and the role of major companies has shown no significant upward trend.

Mergers and acquisitions have caused significant changes in the organization of ownership in retail product markets. In some cases, major companies have withdrawn from large areas of the country and sold their marketing assets to independent marketers. In other cases, majors have exchanged marketing assets with each other in an effort to reduce overall marketing costs. In still other cases, joint ventures have been formed with foreign oil producers seeking outlets for their oil production in the United States. All major transactions of this type have been reviewed by the Federal Trade Commission and the Department of Justice to assess possible anticompetitive implications. None were challenged, though in some cases the prior sale or spin-off of certain assets were required to forestall possible anticompetitive consequences. The antitrust agencies have used EIA marketing data to evaluate changes in market structure associated with these restructuring activities and have concluded that regional markets are still sufficiently unconcentrated to promote competitive performance.

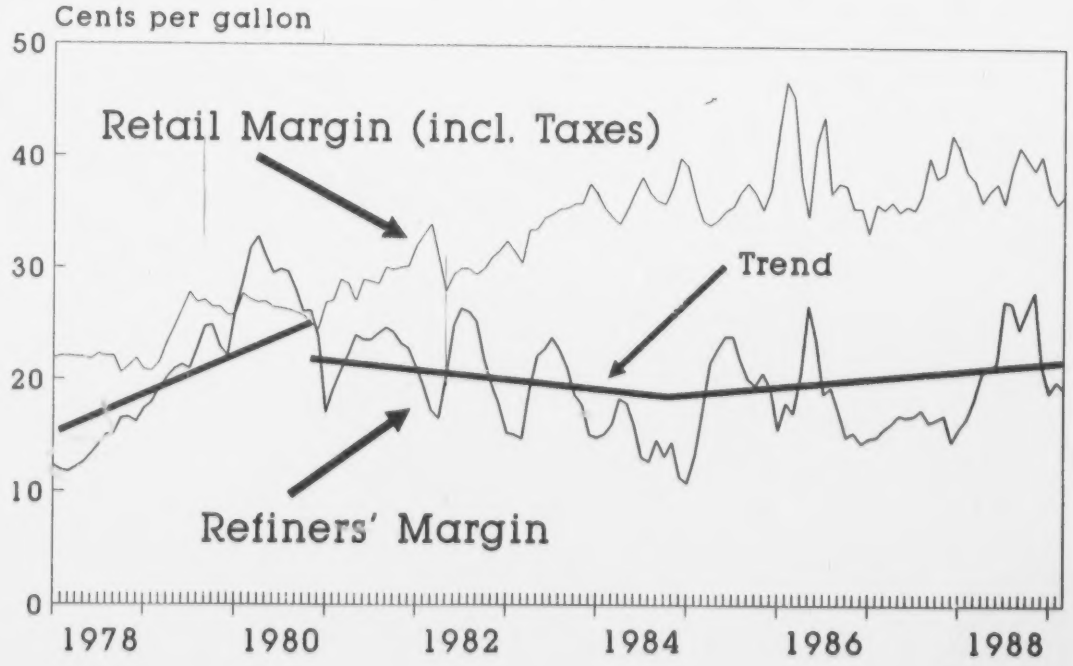
The availability of refined product imports is an additional source of competitive pressure within U.S. refining/marketing markets. Net product imports equal about 10 percent of U.S. supply. More than one-third of U.S. residual fuel oil is obtained through imports. For distillate and jet fuel the share is 10 percent and for gasoline about 5 percent. The actual composition of imports varies on a seasonal basis. Over time, gasoline imports have increased in importance relative to other products. Though some imports move under long-term purchase contracts, much is purchased on a spot market basis. The increasing range of opportunities to purchase crude and product on a spot or short-term contract basis has made it possible for many buyers to seek profit opportunities through participation in petroleum importing activities. The activities of these traders help maintain competitive pressures on domestic refiners and marketers.

Table 1. Crude Distillation Refining Capacity Concentration Ratios by PADDs, 1980 and 1987 (Percent)

	PADD				
	1	2	3	4	5
Two-Firm Concentration Ratio					
1980	23.5	24.1	20.4	28.7	38.4
1987	28.8	23.0	23.2	31.9	38.8
Four-Firm Concentration Ratio					
1980	41.5	37.4	33.9	52.3	54.3
1987	49.5	40.4	35.7	54.8	56.5

Source: Energy Information Administration, Petroleum Supply Annual.

Figure 1. Gasoline Margins
(Cents per Gallon)



Energy Information Administration

FIGURE 2. GROSS REFINERS' MARGINS

& INDEPENDENTS' RETURN ON EQUITY

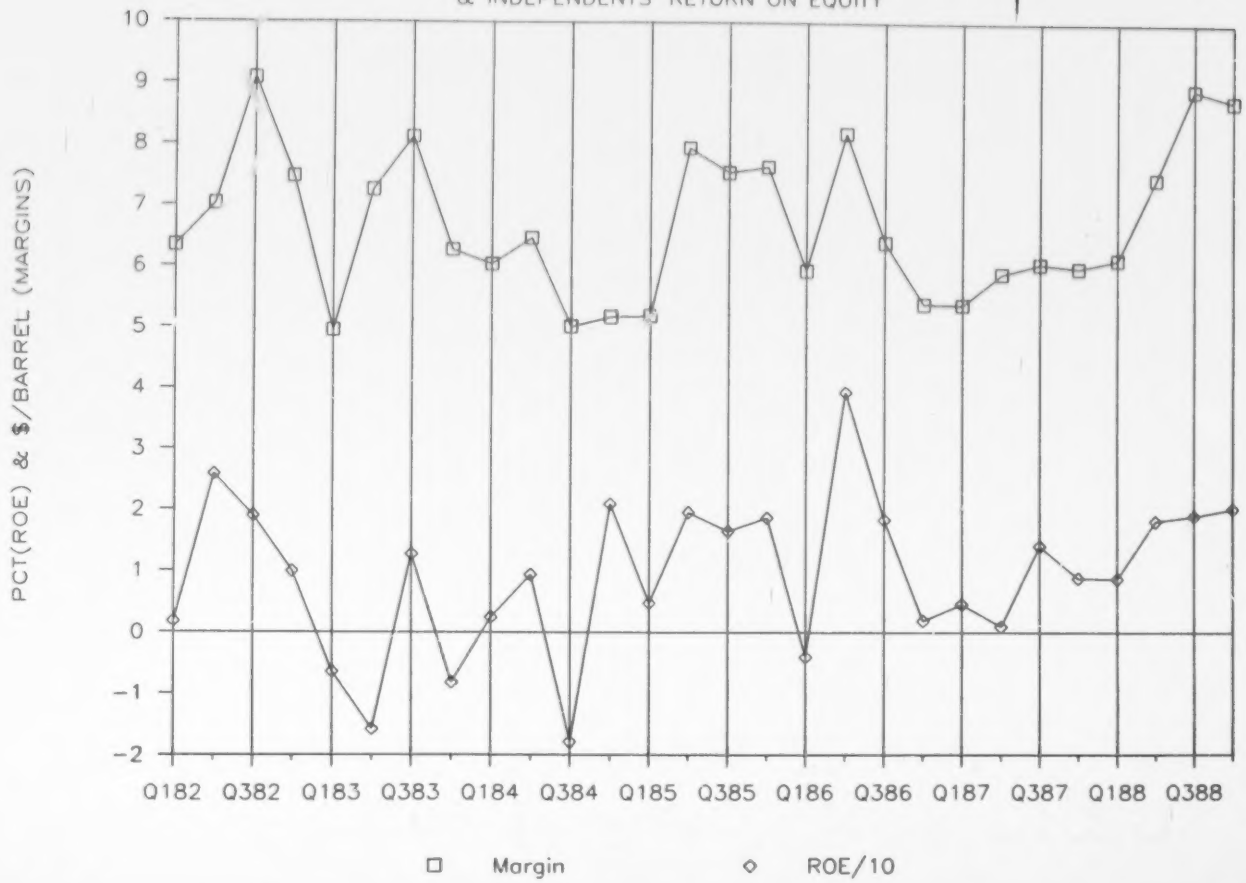


FIGURE 3. MAJORS' OPER. RATE OF RETURN

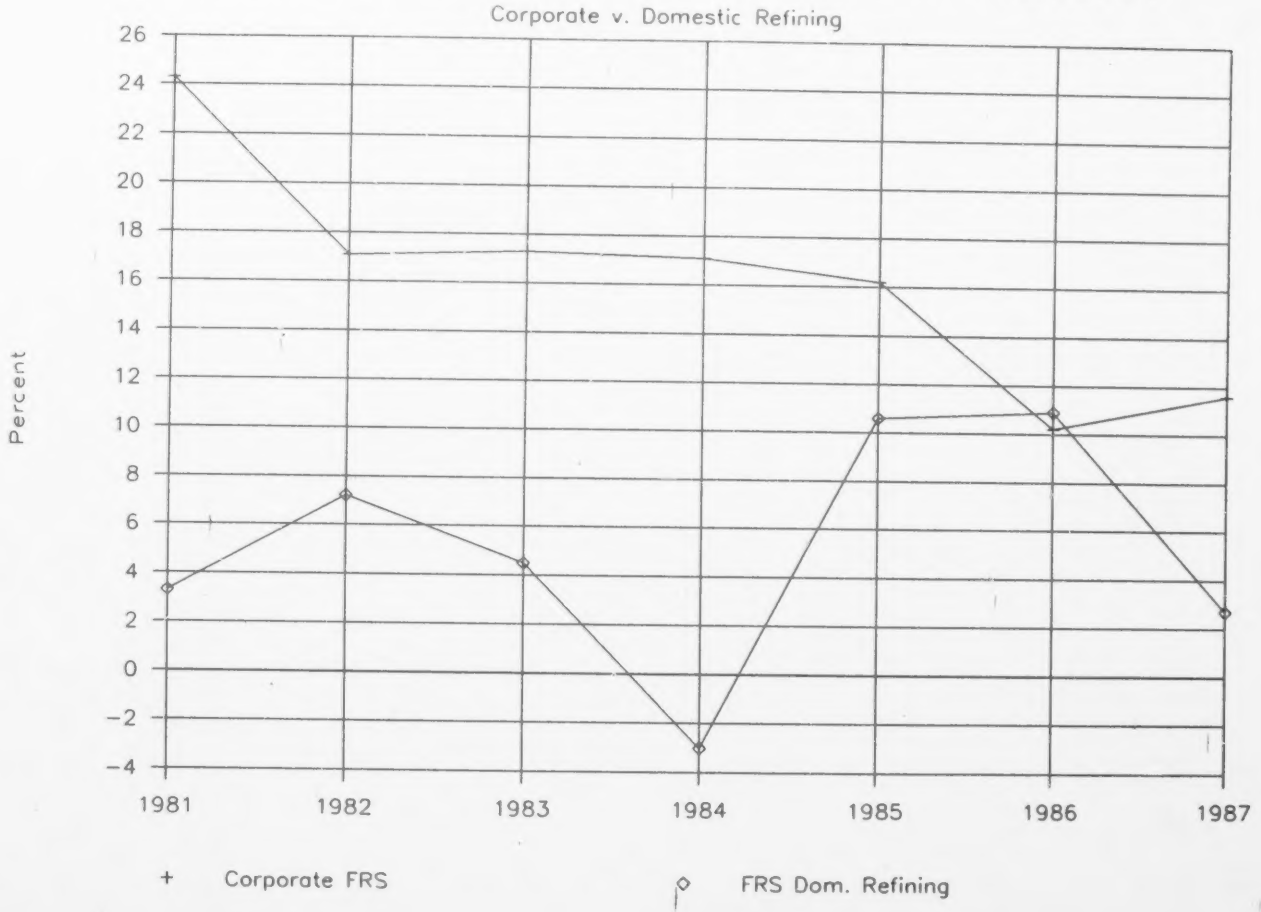


FIGURE 4. S&P 400 v. MAJORS

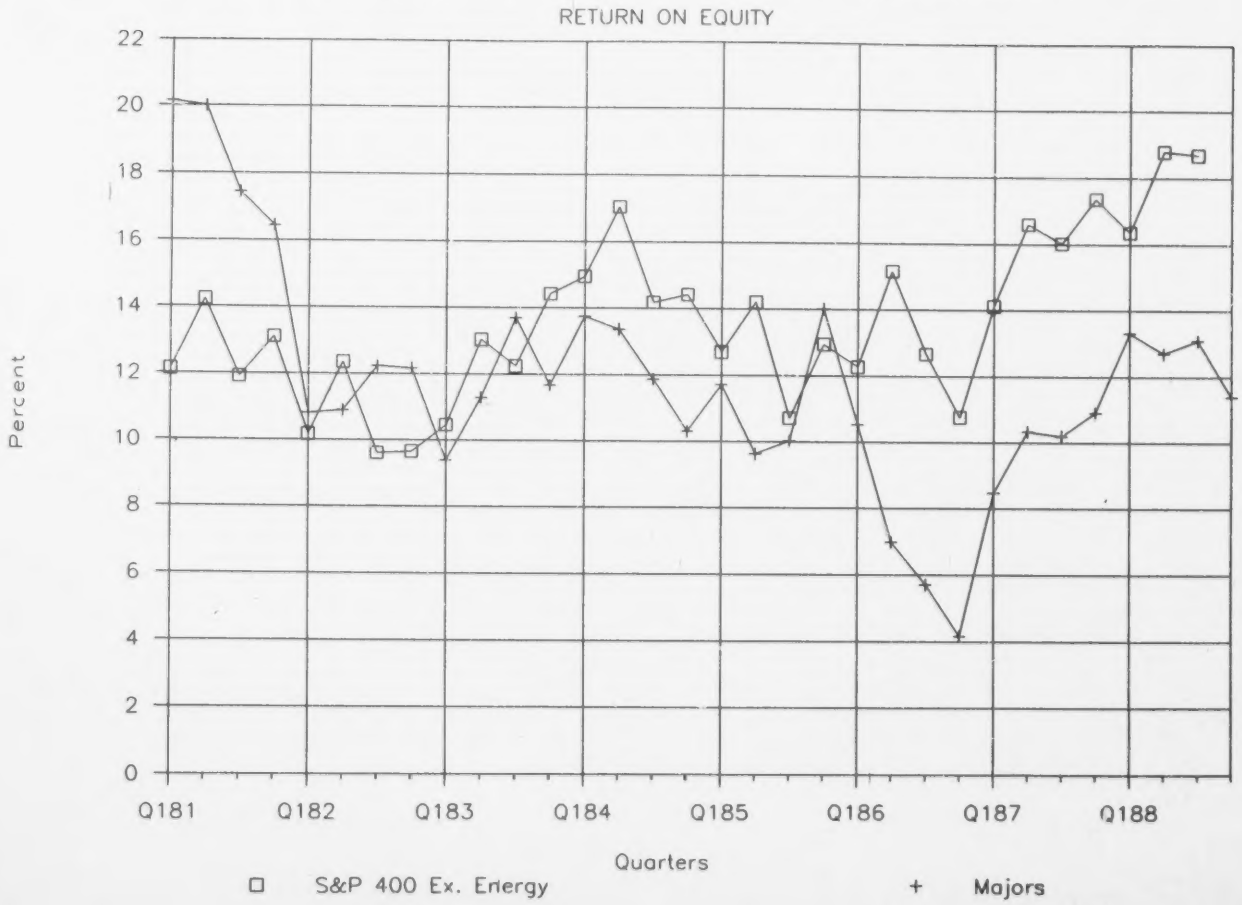
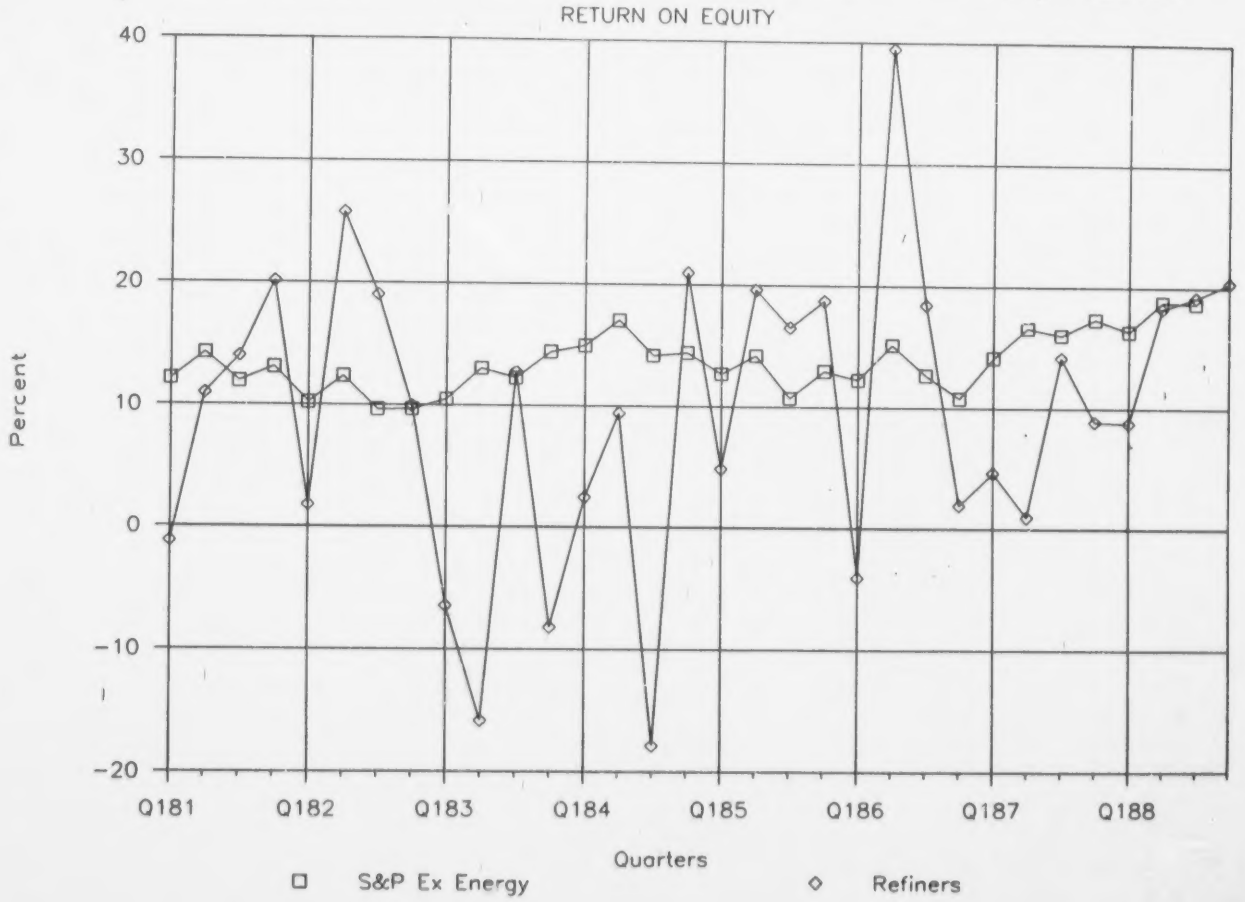


FIGURE 5. S&P400 v INDEPENDENT REFINERS



The CHAIRMAN. I hate to burden you down with too many reports.

Mr. MOORE. Senator, these are good questions and certainly we will do it. Obviously, we agree with your conclusion. Anytime you import oil, it is not good for the Nation's energy security or national security, it is not good for our balance of trade.

You are indicating you think it may also not be good for competitiveness in this country between suppliers and refiners of oil, and that is something I cannot give you an answer to today.

I agree with your conclusion. We will go back and see if there is evidence to sustain that.

The CHAIRMAN. Thank you very much.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Senator Johnston.

Senator McClure.

Senator MCCLURE. Thank you, Mr. Chairman. And thank you, Mr. Secretary.

I assume you are familiar with the April 1987 report of the Energy Information Administration in the Petroleum Marketing Monthly that was authored by Mr. Shirkey and Mr. Speir. I understand that what you are now doing, you will soon be able to give to us, is an update of this information.

This analyzes the differences between crude oil marketing in California and in the balance of the country.

Mr. MOORE. Yes, Senator, we will do that.

[The information follows:]

EIA has updated the data showing the relationship between crude prices in California and the Gulf Coast (Texas). Graphs of spot prices and wellhead prices (as measured by first purchase date collected by the Energy Information Administration) cover the period from 1984/85 to early 1989. (See Figures 11 and 12.)

FIGURE 11
GULF AND WEST COAST SPOT CRUDE PRICES
1985 TO 1989

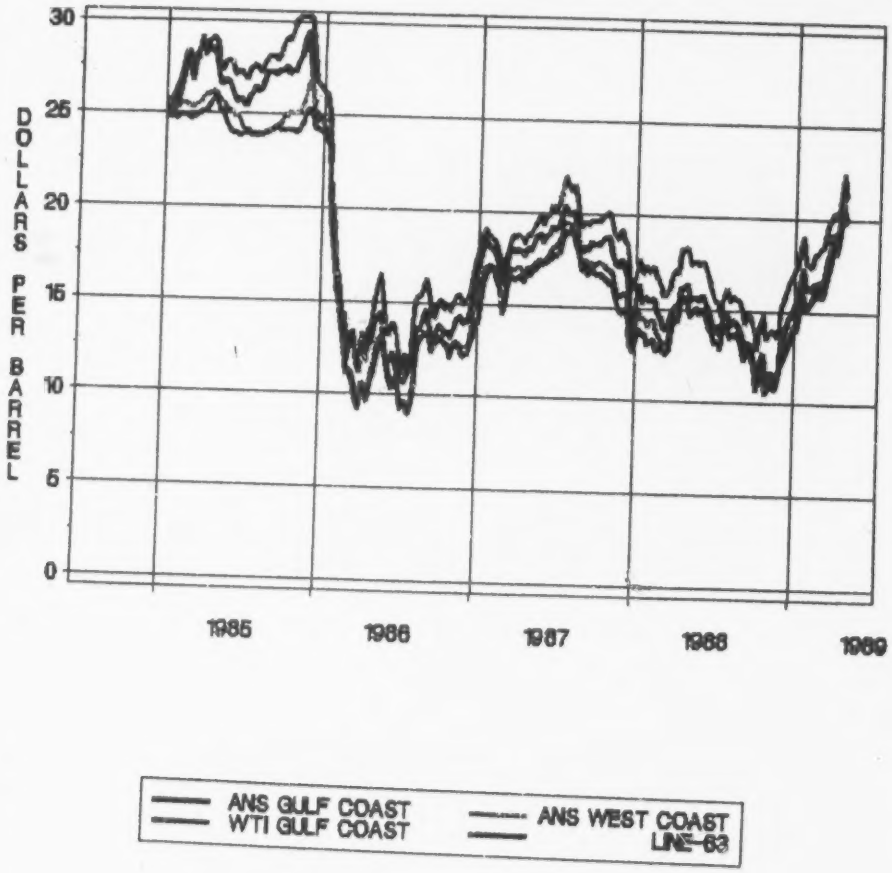
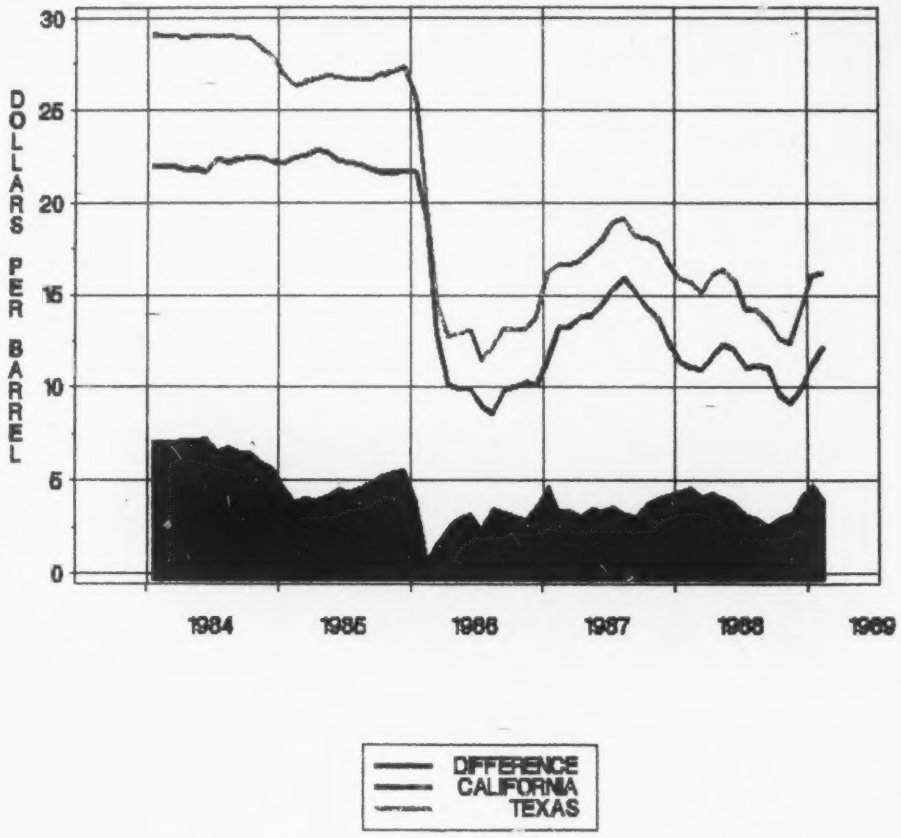


FIGURE 12
CALIFORNIA AND TEXAS FIRST PURCHASE PRICES
1984 TO 1989



Senator MCCLURE. Has there been any other updating of that 1987 report prior to this time?

Mr. MOORE. No, Senator, we do not know of one.

Senator MCCLURE. And I do not want to do any more than only make reference to it, but I note on the concluding remarks that appear on page 19, after having gone through several of the different factors, it makes this statement:

"No one of these possible causes is sufficient to explain why California gross margins are larger than those east of the Rockies, even after adjusting for quality differences." And it goes on from there.

And that is pertinent to the current question that is being asked. It also indicates that this problem, this phenomenon, has existed for a long while.

Mr. MOORE. Well, it may well have, Senator. This morning we were going over the wholesale prices in California. We saw them move quickly and move first, before other markets in the country, and they also seemed to move a little greater, in that one of the analysts in the meeting this morning indicated that he did not know why that was. That is something we really want to study. We do not have an answer for that.

But there is something unusual in California in terms of prices, and we cannot put a finger on it more than that. We saw it move quicker than other parts of the country and a little bit more.

Senator MCCLURE. That existed long before the oil spill off the coast of Alaska.

Mr. MOORE. Yes, it was going on last year for sure.

Senator MCCLURE. Well, and it apparently was going on prior to 1987 when this report was filed. Whatever that phenomenon is, it may be independent of the question of the oil spill.

There was a brief interruption or a threatened interruption of Alaskan supply earlier this year, as I recall, very marginal, very temporary, very small. But it also had consequences in the market, immediately in the spot market, did it not?

Mr. MOORE. We do not have the figures in front of us, so we cannot really agree or disagree.

Senator MCCLURE. As I understand it—the staff has given me this note. I had made some comment or question earlier about where does the Alaskan crude go, and I will ask you if this is approximately what you believe to be correct: 70 percent of it stops on the West Coast or, to be more exact, 68 percent of it does; and two percent goes to Hawaii.

The balance of it, 30 percent of it, goes to points east of the Rocky Mountains and east of the Panama Canal. Well, 30 percent of it goes through the Panama pipeline. 17 percent of it goes to the Gulf Coast, three percent to the Midwest, two percent to the East Coast, and eight percent to the Virgin Islands.

Is that the same as your information?

Mr. MOORE. Without figuring the percentages, I have in front of me the figures of: two million barrels a day that we are bringing down to the United States from Alaska; 1.4 million barrels a day are going to the West Coast and Hawaii markets; half a million barrels a day are going through the Panama pipeline to the Gulf Coast refineries; and .1 million barrels are going to the Virgin Islands, around Cape Horn.

So those figures should be fairly close to yours, if not the same.

Senator McCLURE. Referring to the April 7 report of the Energy Information Administration and the charts I made reference to earlier—I do not know whether you have that report in front of you or not.

[Pause.]

Senator McCLURE. Page 21 in the report indicates—it has two charts in it, one being the spot industry product prices, and that is in U.S. dollars for a 42-gallon barrel, and it shows the spot prices in the Rotterdam market and the spot prices in the New York market.

And they show very steep price rises of product, leaded gasoline being the dotted line on both charts. As I read those charts, there is a very sharp rise in price, in product price, that began in February, is that correct?

Mr. MOORE. Yes, Senator.

Senator McCLURE. And continued through March. That price rise was under way in both the Rotterdam market and the New York market prior to the Exxon spill, is that correct?

Mr. MOORE. Yes, Senator.

Senator McCLURE. Thank you very much.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Senator McClure.

Senator Burns.

Senator BURNS. Thank you, Mr. Chairman. I have just a couple of questions, I guess.

Mr. Moore, we know that demand drives the market in more cases than—and the spot market we know is a very volatile market. In fact, it is just like playing the futures market. You know, you try to buy on fact and sell on emotion, and I think probably that is what we did in this case.

And we are told that there is a glut of crude in the world, that we have a lot of crude oil around. Are we being misled? Do we have a lot of crude oil around the world?

Mr. MOORE. We do not have as much in the United States as we would like to have. Some of the countries that are exporting to the United States do have large proven reserves.

Senator BURNS. Then I guess what we come then, it boils down to mainly market here, if we use that analogy, that number one, we are into a season where we have seasonal increases in gasoline because of demand. America starts to move again. Vacations start, and in our state especially, Montana, we have seen those prices just edge up a little bit, not a lot, but just a little bit.

And then you couple that with, as it has been pointed out here and very well substantiated, that this increase started way last fall, prices for crude. Then that would lead me to believe that the spill would have a minimal effect on retail prices.

Now, I guess I am sort of leading you and I am wondering if you are not drawing the same conclusions.

Mr. MOORE. Senator, we did draw the same conclusions. We do not believe the interruption of the 13 million barrels of oil from the Valdez tragic incident in any way justified, by itself, any kind of lasting or meaningful price increase.

Senator BURNS. That is all the questions I have. Thank you very much, Mr. Chairman.

Senator METZENBAUM. Thank you very much, Senator.

Thank you very much, Mr. Moore. We appreciate having you here before us. I think this is your first appearance, at least in any Committee I have been chairing.

Our next witness is Mr. J.T. McMillan, Senior Vice President of Downstream Business of Exxon Company. Mr. McMillan, we are very happy to have you with us. As you know, the Committee has a five minute rule. However, if you need a few extra minutes, since I think you are that company most discussed, I think that the Chair would be irresponsible if I did not allow you a few additional minutes if you feel you need them to make your presentation.

Please proceed.

STATEMENT OF JOE T. McMILLAN, SENIOR VICE PRESIDENT, DOWNSTREAM BUSINESS, EXXON CO., USA

Mr. MCMILLAN. Mr. Chairman, members of the subcommittee, thank you very much.

I am Joe McMillan, Senior Vice President for Downstream Business of Exxon Company, U.S.A. I am here today to talk about petroleum prices in the United States and will briefly summarize my written testimony. I would appreciate it if you would enter into the record the full written statement.

Senator METZENBAUM. The entire statement will be included in the record, as well as every other witness' entire statement. If you could just shorten it in order to constrain yourself within the time limits.

Mr. MCMILLAN. Thank you, Mr. Chairman.

Claims that recent increases in crude oil and petroleum prices are largely the result of the Valdez incident are incorrect. The Alaskan oil spill affected the supply of crude oil to the West Coast of the United States for only a short period of time, and its effect on overall U.S. petroleum product prices was minimal in relation to other factors.

The price of gasoline was increasing prior to the Valdez incident in response to raw material cost increases, seasonal effects, increased regulations, higher cost imports, and added state excise taxes.

The largest single cost component of gasoline, crude oil, has been rising since mid-November of last year, largely due to OPEC actions. During this period, the price of crude has increased by six dollars a barrel or 15 cents a gallon. There was some increase in crude oil prices at the time of the Valdez spill, but that was short-lived, as prices returned to the pre-incident level within a week.

Over this same period, average U.S. gasoline prices at the retail level have increased about ten cents a gallon, while Exxon's prices to dealers were up even less—about seven cents a gallon.

This is quite a bit below the 15 cent per gallon increase in crude oil cost. In fact, according to the New York Times' on-the 13th day of April industry experts point to crude prices as one of the two factors mostly responsible for recent retail gasoline price increases. The other factor they cite is the onset of summer demand.

Gasoline prices are seasonal and normally increase as suppliers prepare for the approaching spring and summer driving season. Also, as was clearly detailed in hearings, controls on the vapor pressure of gasoline by both the EPA and most northeastern states are increasing gasoline costs by one to three cents a gallon.

Further, the cost of imported spot gasoline needed to meet U.S. demand has increased more than domestic supplies and was seven to ten cents a gallon above the East Coast prices last week.

Increased state taxes are also contributing to higher prices in selected areas of the country, by up to five cents a gallon.

When viewed in the context of all these factors, the disruptions resulting from the Alaskan spill are minimal for most areas of the country. On the West Coast, gasoline prices have increased by a greater amount, about 16 cents a gallon since mid-March. Over this period, our own price to West Coast dealers increased about ten cents a gallon.

In addition to the other factors I mentioned, more West Coast gasoline is supplied by local refinery runs. So with the lead time required to bring in Gulf Coast or imported supplies, the impact of temporary disruptions on prices is more pronounced.

We responded to the reduced supplies by acquiring imported crude for our California refinery and shipping products from our Gulf Coast refineries. We have been able to meet 100 percent of our distributors' contracts and our dealer demands on the West Coast, with no significant outages.

Even on the West Coast, where markets were most affected, prices are already declining as refinery operations have returned to normal and Gulf Coast and imported shipments of gasoline arrive. In fact, spot gasoline prices in Los Angeles, which reacted the most, have dropped by 20 cents a gallon from the peak; that is, from $1.02 per gallon on the 30th day of March to 82¢ per gallon last Friday.

The idea that Exxon raised gasoline prices to profit from the spill is completely unfounded. Gasoline prices are set by the interactions of thousands of individual sellers and buyers wl o operate in a very competitive market. The marketplace will not permit any unusual costs incurred by a particular supplier, like the costs necessary to clean up the oil spill in Alaska, to be recovered in the marketplace.

So in summary, the price of gasoline was increasing prior to the Valdez spill in response to a number of factors. And when viewed in the context of all of these, the disruptions resulting from the *Exxon Valdez* incident were minimal for most of the country.

I would like to make one additional point not in my written testimony, Mr. Chairman. There has been a lot of discussion this morning about the California crude price situation. The discussion relates to a suit that was brought in the mid-1970's and the State's claim in that suit has been rejected by the Federal district court in Los Angeles after receiving testimony from hundreds of witnesses and reviewing thousands of documents.

The court granted summary judgment in Exxon's favor. The case is or appeal now to the Ninth Circuit Court of Appeals, and we are confident that will be upheld on appeal as well.

Senator METZENBAUM. What was the thrust of that case? What was the contention in that case?

Mr. MCMILLAN. It was a question about California crude prices and a conspiracy to hold down the California crude prices.

Senator METZENBAUM. Is that the same issue where Arco settled for $21.5 million?

Mr. MCMILLAN. Yes, sir.

Senator METZENBAUM. So $21.5 million I know is not much to oil companies.

Mr. MCMILLAN. It is a lot to me, Senator.

Senator METZENBAUM. But it is obvious that one company thought there was enough of a case there that they decided to settle the matter. The others—is this one case? Are these cases against the companies individually?

Mr. MCMILLAN. Yes. Well, it was brought together in the court on the West Coast. And we stayed with that and, as I said, were rewarded with a summary judgment in our favor.

I will be happy to answer the questions that I know you have.

[The prepared statement of Mr. McMillan follows:]

Statement of J. T. McMillan
Senior Vice President - Downstream Business, Exxon Company U.S.A.
before the
Subcommittee on Regulation and Conservation
of the Senate Committee on Energy and Natural Resources
of the
United States Senate
April 17, 1989

Mr. Chairman, members of the subcommittee, I am Joe McMillan, Senior Vice President of Exxon Company, U.S.A. I am responsible for Exxon's refining, supply and marketing operations in the United States. I am here today in response to the call of the hearing to talk about petroleum prices in the U.S. Other Exxon witnesses are responding to Congressional requests to address the EXXON VALDEZ incident and cleanup efforts. I do not plan to discuss those areas today except to repeat that we are sincerely and profoundly sorry that the incident occurred and will continue to do all we can to cleanup and mitigate the spill's effects.

Claims that recent increases in crude oil and petroleum prices are largely the result of the Valdez spill are incorrect. Petroleum prices in the U.S. are impacted by a number of factors, including events well beyond the border of the country. The Alaskan oil spill was one such event that temporarily affected the supply of crude oil to the West Coast of the U.S., but its effect on overall U.S. petroleum prices was minimal in relation to other factors. The price of gasoline was increasing prior to the Valdez incident in response to raw material cost increases, seasonal effects, increased regulations, higher-cost imports, and added state excise taxes. Of these, the April 13 New York Times states that analysts and industry experts point to crude prices and the onset of summer demand as being mostly responsible for retail price increases.

Crude Oil Prices

The largest single cost component of gasoline is crude oil. Crude oil prices worldwide have been rising since mid-November 1988. During this period, the price of West Texas Intermediate crude has increased by $6/B (15¢/G).

The Organization of Petroleum Exporting Countries' (OPEC) adherence to a December 1988 accord is the major factor that has led to increased crude prices. In addition, there have been many other occurrences that have caused crude oil price volatility. Several incidents in the North Sea have resulted in supply reductions. These include the Piper Alpha platform fire that has reduced crude oil production by almost 80 million barrels since July last year. By comparison, the spill in Alaska resulted in a loss of 12.5 million barrels. This temporary loss of supply, when compared to a Free World demand of more than 50 million barrels per day, is minimal. There was some increase in crude oil price that occurred at the time of the spill, but that was short-lived as prices returned to the pre-incident level within a week as shipments resumed.

U.S. Retail Gasoline Prices

Retail gasoline prices vary geographically, and since last November average U.S. gasoline prices at the retail level have increased about 10¢/G according to Lundberg surveys. Exxon's price increase to dealers over this same period was about 7¢/G. These increases are less than the 15¢/G increase in crude oil costs that occurred over that period. Of course, the relationship of crude to gasoline is not one-to-one and depends upon many variables including the value of other products. However, many industry analysts have pointed to the impact of higher crude costs on gasoline prices. In March of this year, the retail gasoline market relative to crude price was actually 4¢/G lower than the same time in 1988.

In addition, gasoline prices are very seasonal and normally increase as suppliers prepare for the approaching spring and summer season when driving increases. After recent increases in gasoline prices, Exxon's price to dealers relative to crude is at about the same level as May last year and 10¢/G below the peak of last summer. Seasonal increases in the spring and decreases in the fall are quite typical and are an element in recent retail gasoline price increases.

Further, more stringent gasoline volatility regulations are increasing the cost to produce gasoline. Controls on the vapor-pressure of gasoline by both the Environmental Protection Agency and most Northeastern states are increasing gasoline costs by 1-3¢/G. This effect was clearly detailed in both federal and state hearings.

There are a number of other factors that influence gasoline prices. The cost of imported gasoline supplies is higher since European gasoline prices have been increasing faster than in the U.S. and were about 7-10¢/G above East Coast prices last week. About 400 thousand barrels per day of gasoline imports are utilized to meet demand in this country and 90 percent of them flow directly into the Northeast part of the country.

Fluctuations in gasoline inventories also influence prices, especially at the wholesale level. Gasoline inventories serve not only to smooth seasonal changes but also act as a shock absorber to soften the effects of any operating problems or other short-term fluctuations in supply and demand. Although primary inventories have begun to decline as a result of seasonal demand increases and the unusually high transfers to secondary storage of the past two weeks, they still stand at about the same level as last year.

Finally, increased state gasoline taxes are also contributing to higher prices in selected areas of the country by up to 5¢/G. Also, several states, including California, have percentage gasoline taxes which compound changes in prices.

When viewed in the context of all these factors, the disruptions resulting from the Alaskan spill are minimal for most areas of the country. However, the effect on West Coast gasoline prices was more significant.

West Coast

According to Lundberg, retail gasoline prices on the West Coast have increased by about 16¢/G since mid-March. Over this period Exxon's price to West Coast dealers has increased about 10¢/G. Again, these prices are impacted by essentially all of the same factors I discussed for the total U.S. In addition, most West Coast gasoline is supplied by local refinery runs, and alternate supplies from the Gulf Coast and imports are more remote. With the lead time required to bring in alternate supplies, the impact of temporary disruptions on spot prices is more pronounced. It is important that inventories be built to high levels by late January/early February in order to accommodate normal refinery maintenance activities. PAD V inventories reached 36 million barrels in early February which is a record high.

Exxon Response

Exxon responded to the reduced supplies on the West Coast by acquiring imported crude for processing at our Benicia, California refinery. We also shipped products from our Gulf Coast refineries. We have been able to supply 100% of our distributors' contracts and our dealers' demands on the West Coast with no significant outages. Exxon's price to West Coast dealers last week was at about the same level relative to crude as last May and 8¢/G below the peak in September last year.

The idea that Exxon raised prices to profit from the spill is completely unfounded. Gasoline prices are set by the interactions of thousands of individual sellers and buyers who operate in a very competitive market. Exxon must price its products at market levels for its dealers and distributors to compete. The marketplace will not permit any unusual costs incurred by a particular supplier, like the costs necessary to cleanup the oil spill in Alaska, to be recovered in the marketplace. Those costs must be absorbed by the supplier.

In summary, the price of gasoline was increasing prior to the Valdez spill in response to a number of factors, including crude oil price increases, seasonal effects, increased regulations, higher cost imports, and increasing state taxes. When viewed in the context of all these factors, the supply disruptions resulting from the EXXON VALDEZ incident are minimal for most areas of the country. On the West Coast where wholesale and retail gasoline prices are up more than in the rest of the U.S., wholesale prices are declining as refinery operations have returned to normal and Gulf Coast and imported shipments of gasoline arrive.

Senator METZENBAUM. I do indeed.

You state in your testimony that Exxon's prices to dealers went up about seven cents per gallon. Later today we will hear testimony from Mr. Tom Potter, a wholesaler who purchases from Exxon, that his purchase price from Exxon went up seven cents a gallon before the spill, and an additional 12 cents since the spill, for a total increase of 19 cents. Who is right?

Mr. MCMILLAN. Senator, I am sure he is absolutely right. He is a very good customer of ours, and there are a number of markets here, and obviously that is one of the things that we need to talk about.

You talked about the spot market displayed on your chart. That is probably the most volatile market. It is also the smallest market in the country. There is a market for sales to dealers, and that is the one I mentioned. On an average U.S. basis we are up seven cents a gallon in that market since November.

There is also a market for sales to distributors, and we have a different set of pricing criteria and guidelines there. We are pricing to those customers on the basis of rack prices in this country.

So there is a spot market where it is sold in barges or tanker loads. There is another market where you sell at the rack. There is another market where you sell to dealers on a delivered basis.

So as you are well aware from previous discussions on this, it is a very complex market, and I think any of us can prove almost anything if we take the right period of time and the right market. But it is very complex.

So I am sure my customer is right.

Senator METZENBAUM. I want to say this. You say almost any one of us can prove most anything we make the effort to do so under the circumstances. I have to tell you that I think you have got an amazing burden of proof to convince the American people—and I say this facetiously, but with all seriousness—that the oil companies of this country did not exploit the situation in Valdez.

I think the American people, if you took a poll—and I guess there have been some—would come to the conclusion, I would guess it would be 80–20, where they would think that the oil companies ripped them off in some way related to the tragic developments up at Valdez.

And it seems to me that if the oil companies were not doing that, and here you have dealers—now, I've got retail dealers all over the State of Ohio who are actually going on TV programs, going on radio programs. The dealers are complaining about the increases in the prices, all of which has occurred since the March 23rd date.

And I guess my question to you is, how does the American oil industry—you are the only one that showed up here today. The others were not even willing to do that, nor the American Petroleum Institute.

I do not know what you pay that fellow for if he is not going to show up at Congressional hearings. What does he do for you?

But whatever. I do not understand, how are you going to convince the American people you did not rip them off?

Mr. MCMILLAN. Senator, it is a very imposing job to try to convince them of these things, because I think most of them look at the price at the instant that they see the price change, regardless

of whether it goes up or down. They look to the media for information on what is going on.

There is a lot of talk about specific instances like the Valdez spill, and other interruptions of supply. Like last year—there was a very serious interruption when there was a fire and an explosion at one of the refineries in Senator Johnston's home state of Louisiana.

So prices are very complex. They are not set directly one to one by cost. There is a lag among the different markets. The spot market reacts very quickly. The price to our dealers reacts much more slowly.

So I agree we have quite a burden to try to convince them that we have priced over time in a very, very reasonable manner.

I would like to make one point that was made earlier. If you look at the gasoline prices today as a percent of disposable income, it is at the lowest level it has been in 20 years. So gasoline is still, up through 1989 year to date, a very, very good bargain, I think.

Senator METZENBAUM. Mr. McMillan, you say on page 2 of your testimony that gasoline inventories serve to smooth seasonal changes and act as a shock absorber for changes in supply and demand. Your inventory is about the same as last year, and the trade press has reported that national inventories are very high.

Why did not those inventories cushion the price hikes so that you would not have had to take that which you have to feel somewhat uncomfortable about, and that is the public criticism and abuse about the fact that prices went up at such an inordinately high rate immediately after Valdez?

Mr. MCMILLAN. I think the inventories are adequate in this country, and they do take some of the shock out of the system. I think that that is one of the reasons that you see crude oil is up 15 cents a gallon and gasoline is only up 10 cents a gallon.

As you go into the winter period, the price relative to crude declines. As you go into the summer period, the price of gasoline relative to crude begins to increase.

If you look at 1989 up until today and you look at the price of gasoline relative to crude, it is one and a half cents a gallon lower than it was this same time last year. So inventories do come into effect, and that is part of the reason that you see a lag in the prices; that is because of the seasonal effect of the inventory that is available.

Senator METZENBAUM. Now, after Valdez did Exxon declare force majeure, which pretty much is to say it was an act of God, it was beyond your control?

Mr. MCMILLAN. Senator, for our crude contracts on the West Coast, where we sell North Slope crude, we did declare force majeure. We have a specific provision in our contract that allows us to do that. It includes disruption of transportation.

We have now raised that factor back to 100 percent, so we are supplying 100 percent of what we had in our contracts for the month of April.

Senator METZENBAUM. What did you do to calm the markets after the spill? Did you try to make up any of the lost supplies from other sources, such as Mexico, Venezuela, Saudi Arabia, or other inventories that were available from even other companies,

so as to calm the market and assure supplies for refineries and consumers?

Mr. MCMILLAN. Mr. Chairman, on the West Coast we moved immediately to do two things. We did acquire additional supplies of foreign crude to move onto the West Coast, about 700,000 barrels of crude. By Monday after the incident on Good Friday, we had already chartered two additional tankers to move a half a million barrels of gasoline from Exxon's refineries in the Gulf Coast to California.

So we have responded very quickly and very responsively to bring added supplies in to California.

Senator METZENBAUM. Could not Exxon have held the line on retail prices at company-owned stations nationwide, which would have been sort of a signal to the rest of the companies in the industry?

Mr. MCMILLAN. Senator, I have been up here before and talked to you about this. I am sure if I would have held down the prices at the company stations and the dealer price went up, I would be in a lot more trouble than I am today. So that would have been a very serious problem for me and for our dealers as well.

Senator METZENBAUM. For your who as well?

Mr. MCMILLAN. For our dealers.

Senator METZENBAUM. Let me tell you, your dealers and dealers in gasoline stations have not been on your side in this instance. They have been more outspoken in this instance than any time in my senatorial career, and I have certainly had more than a little involvement with respect to oil prices and the oil industry.

But the retail dealers in this instance are solidly concerned about the fact of increased prices to their customers without being able to—which they did not want to pass on, but had no choice by reason of the increased wholesale prices.

Mr. MCMILLAN. Senator, we have worked as hard as we know how to communicate with our dealers as to what the situation was with the spill in Valdez and what is going on with gasoline supplies. We feel a real obligation.

About 90 percent of our branded gasoline in this country is sold by independent dealers and distributors, and so we are very concerned, obviously, with our relationship with those groups, and we have gone out of our way to communicate with them.

We have not been able to get the whole story to them. We have not been able to convince all of them. But we have sure worked to communicate with them, because that is an important channel of sales for us.

Senator METZENBAUM. The last question before I turn it over to Senator Johnston, let me ask you a question about Texas. I wrote to the EPA Administrator and the FERC Chairman and received their assurances last year that a regulated natural gas pipeline, Texas Eastern, would not be able to pass on to ratepayers the cost of the cleanup of unlawful PCB pollution as an expense.

Last week Exxon announced it intends to take cleanup expenses as a tax deduction against income, thus saddling the taxpayers with about a third of the bill. Why should not your company make the American—why should your company make the American tax-

payer foot the bill for the environmental catastrophe caused by Exxon in Alaska?

If Exxon is allowed to take such a deduction, its after-tax income will go up, and I just do not understand why, as a gesture of goodwill, Exxon would not be prepared to say that, it was our fault, it should not have occurred, we are very much dismayed about it, we claim we did not cause prices to go up to the consumer as a consequence, but we certainly are not going to pass on to the rest of the American taxpayers approximately one-third of the cost of the cleanup.

Mr. McMILLAN. Senator, we have apologized for the incident and we are very sorry about it, as you know. I think, though, that if you look at the situation, we are by no means trying to take advantage of any tax break. Any legitimate business expense can be deducted from our before-tax income in order to look at how much income tax we owe.

The thing you have to remember is the taxpayer does not end up paying for this. The costs associated with the spill reduce our income tax. But we pay those costs out to people to clean up the spill, and to provide supplies.

So there is income generated on the other side of that equation. Tax is paid on that income. So I do not believe that the American taxpayer is going to end up paying anywhere near 34 percent of that cost, because you are going to see both sides of the equation. It reduces our tax; but other people's incomes increase, and their taxes ought to be increased by a like amount.

Senator METZENBAUM. Are you saying that all of that money that you are paying out will be reflected in increased taxes, when we all know that some people have different tax brackets, some people have loss carryforwards or losses, some people have artificial losses?

So I think that the bottom line is that, whatever your costs may be, if you proceed as currently indicated and absent the passage of the Reid bill, I think that you will be milking the American taxpayer for about a third of the cost of the cleanup.

Mr. McMILLAN. Senator, I do not believe it will be anywhere near that. I think the bulk of that spent by Exxon will show up in other's income and related taxes will be recovered by the U.S. government.

Senator METZENBAUM. Thank you.

Senator Johnston.

The CHAIRMAN. Yes. Thank you, Mr. Chairman.

Mr. McMillan, can you tell me, do you know on a day to day basis what your margins are at the refinery, at the distribution, at the pump?

Mr. McMILLAN. Senator, I would never claim I know them on a day to day basis, but I pretty well on a weekly basis do know what they are.

The CHAIRMAN. All right. Can you offer any hope to the American gasoline buyer that prices will come down at the pump? In other words, are margins now a little higher than they have been historically?

Mr. McMILLAN. Senator, for the first quarter of this year, for which I do have pretty good information, our margins are much

lower than they were in 1988. And of course I cannot speculate on what is going to happen to gasoline prices in the future, but our margins so far this year are lower than they have been.

Right now, if we could split between a refiner's margin and marketing margins, which I am not sure we can, the refinery margin is at a reasonable level. However, our marketing margin is still quite low, and we have not been able to pass through all of the increased costs of crude that we talked about earlier.

The CHAIRMAN. Okay. The prices at the pump over a period of time, you are saying in effect, have gone up pretty much in lockstep with the price of crude?

Mr. MCMILLAN. Well, as I mentioned, crude is up 15 cents a gallon since November and our prices at the pump are up only ten cents a gallon, even through today.

The CHAIRMAN. So all these fluctuations. There is a lot of emotion built in that, but in terms of the real price at the pump you are saying that those are caused by your costs, principally crude oil?

Mr. MCMILLAN. That is true, and what I should have said is our wholesale prices to dealers are up seven cents a gallon. Crude price is up 15 cents a gallon, and the U.S. average retail price is up 10 cents a gallon, and I misspoke on the earlier response.

So at the wholesale level Exxon has not recovered even half of the increase from crude oil since November.

The CHAIRMAN. Are you saying that prices at the pump are likely then to go up?

Mr. MCMILLAN. Senator, I have been down this one before and I just would not want to speculate on that. As you know, they go up and down, and there are a lot of factors that affect them. But I could not speculate on which way they are going to go.

It is a very competitive market, regardless of what some people say. There is a tremendous amount of competition out there.

The CHAIRMAN. Why is there a regional disparity between the price of gasoline?

Mr. MCMILLAN. Senator, a lot of factors affect that, I think. Obviously, one of the things that affects it is the different taxes in each one of the states. The level of state excise tax varies quite a bit. California, for example, in addition to a nine cent state excise tax, has a 6-1/2 percent sales tax. A number of the states do have sales tax in addition to excise tax.

So there is a great variation across the country in the amount of tax that is collected by the state. The other thing obviously that impacts it is the margin that the dealers are able to recover. In some areas of the country, the throughputs are much greater in stations than other areas. Dealers in these areas do not require as high a cents per gallon margin as those do in other areas in order to have a profitable business.

The costs of regulations are different. We just talked about the regulations on vapor pressure. If we have to go down to a nine pound vapor pressure in the Northeast states which is now proposed, other factors being equal, the cost of gasoline to that area is going to be significantly above an area where the vapor pressure does not have to be reduced.

The CHAIRMAN. Mr. McMillan, thank you very much for coming to testify. We appreciate it. We know some of the other companies did not want to come to this lion's den, so we appreciate the fact that you did. Thank you.

Mr. MCMILLAN. Thank you, Mr. Chairman.

Senator METZENBAUM. Senator Nickles.

Senator NICKLES. Mr. Chairman, I do not have any questions for the panelist. I appreciate his statement. Thank you.

Senator METZENBAUM. Well, I do appreciate your coming, as has already been suggested. You concluded that you ought to come forward and share with us the information and answer our questions. And maybe some of the other Committee members have questions.

And we appreciate it. Even if we do not appreciate some of the things that have occurred, we do appreciate your being with us today.

Mr. MCMILLAN. Thank you very much, Mr. Chairman.

Senator METZENBAUM. Thank you.

Our next panel of witnesses is: John Lichtblau of the Petroleum Industry Research Foundation; Edwin Rothschild, Assistant Director of the Citizen/Labor Energy Coalition; Tracy Stanton, Past President, Service Station Dealers of America—Mr. Stanton comes from my own state, in Bexley, Ohio—and Tom Potter, President of Potter Tire and Oil in Morehead City, North Carolina, and a Past President of the Petroleum Marketers Association of America.

We are happy to have all four of you with us. I think you know the Committee's rules about a five-minute presentation. Since the hour is growing rather late, my guess is we will adhere strictly to that schedule.

Our first witness is Mr. Lichtblau.

STATEMENT OF JOHN H. LICHTBLAU, PRESIDENT, PETROLEUM INDUSTRY RESEARCH FOUNDATION, INC.

Mr. LICHTBLAU. Thank you very much. I will try to condense what I have to say in five minutes. So much of it has already been said.

Basically what we know is gasoline prices have risen since the oil spill, since March 24th, at an unusually rapid rate, estimates are between 8 and 12 cents a gallon, depending on what source you use. Most of that increase has occurred since the oil spill. Therefore there is a question: Is there a cause and effect relationship between the Alaskan oil spill and the increase in gasoline prices?

It is not so easy to have answers, because the period since the Alaskan oil spill is still very brief and there are not very many data available yet. We have tried to look at gasoline and crude oil prices for the period before March 24th and the period since March 24th.

We looked at gasoline and crude oil prices because the most important single cost factor in gasoline prices is the cost of crude oil. It is about 70 percent of the wholesale price and 50 to 60 percent of the retail price of gasoline. So it is the one factor that is more important than anything else in setting gasoline prices.

What we have seen, as has already been pointed out, is that crude oil prices rose substantially from the low point of early No-

vember 1988, when they were about $12.50 a barrel, under $13 a barrel, to about $20 just the day before the Alaskan oil spill, an increase of $7.50 roughly or 18 cents a gallon.

These increases normally are passed on in retail and wholesale prices of gasoline with a lag, so that it was not expected that it would immediately show up. But the lag is somewhat larger, somewhat longer than normal, and I think one of the reasons was that these price increases occurring in crude oil in the first quarter were sort of unexpected.

There was a general view that OPEC had been overproducing substantially and that in the first quarter OPEC prices, world prices, would weaken rather than strengthen. And for a number of extraneous, non-recurring reasons both on the supply and the demand side, something else happened: crude oil prices kept rising.

And by early to mid-March, it was clear that it was not just a very brief spike in prices, and from then on you saw a beginning of passing these increased costs through in higher gasoline wholesale and retail prices. So by the time the accident happened, you already had begun to see the first evidence, particularly in the wholesale level, of higher prices.

But basically, they had not been passed through. For instance, gasoline prices on the 18th of March were no higher than they had been in November 1988, while, as I said, there was an 18 cent increase.

Generally, on the even of the——

Senator METZENBAUM. I did not quite understand. You said they were not any higher and then you said there was an 18-cent increase?

Mr. LICHTBLAU. There was an increase from the beginning of the year, but if you go back to November and compare it with March 17th, the last date that we have before the spill, there is virtually no increase, according to the Lundberg Survey, in U.S. average gasoline prices.

As I say, wholesale prices did begin to increase in early to mid-March. The general market expectation on the eve of the Alaskan accident was that world crude oil prices had approximately peaked and would possibly even decline somewhat, but that gasoline prices were bound to increase, for the factors I have just mentioned.

If you asked any analyst on Wall Street or anywhere else in mid-March what he expected for gasoline and crude oil prices, he would have said they will move either in opposite directions or one will go up and the other one might stay where it is.

The situation was somewhat different on the West Coast. As has already been pointed out, wholesale prices did increase significantly on the West Coast from mid-February on, something like 16 cents a gallon, between mid-February and the day before the oil spill.

And retail prices also rose on the West Coast, not as much, but about 6½ cents, from the beginning of February to the 24th of March.

Now, as a result of the spill you had of course a loss of 13 million barrels of oil. That is not very much, but over a brief period like two weeks it is the equivalent of a million barrels a day, and that

is significant. So that you suddenly had a loss in a market, totally unexpected, and it had certain consequences.

And we heard about force majeure by two major oil companies. Another refinery started to cut its runs because they wanted to conserve crude oil.

It spread beyond the West Coast, because 500,000 barrels a day of Alaskan crude do come to the Gulf Coast. That is not an insignificant amount, and that was not available, or at least there was a fear it would not be.

Furthermore, as the gasoline shortage, the gasoline situation, deteriorated on the West Coast, you saw gasoline shipments from the Gulf Coast to the West Coast, not a great deal, but maybe something like ten cargoes. It is a very unusual movement. Normally gasoline at the Gulf Coast goes inland, to the East Coast by pipeline, but never to the West Coast.

This was an unusual shipment and it had an impact. But basically, the price increase that occurred was the result of an event which had happened earlier, and now that Alaskan production is back to normal you may possibly see a leveling off in gasoline prices.

You will not see a return of gasoline prices to the pre-spill period, because factors other than the oil spill have caused the increase and, unless crude oil prices should decline or unless possibly the increase in gasoline prices should cause a decline in gasoline consumption, you will not see gasoline prices go back to anywhere near where they were.

In fact, it is possible that other cost factors could increase it somewhat. I am specifically referring to the vapor pressure restrictions which are now being put into effect throughout the Northeast and which may cost two or three cents a gallon and lose the gasoline refinery industry something like 150,000 barrels a day in capacity.

May I go on?

[The prepared statement of Mr. Lichtblau follows:]

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THE RISE IN GASOLINE PRICES

Statement by

JOHN H. LICHTBLAU

Before the

Subcommittee on Energy Regulation and Conservation

of the Committee on Energy and Natural Resources

U.S. Senate

April 17, 1989

THE RISE IN GASOLINE PRICES

Outline of Testimony

I. SUMMARY: *Retail motor gasoline prices have recently risen sharply, by 10.9 cents per gallon from March 17 to April 7, according to the authoritative Lundberg Survey. Some observers have erroneously pointed to the Exxon Valdez oil spill in Prince William Sound as the "cause" of the increase. However, gasoline prices had been poised to rise before the March 24 spill. Since their low point in late 1988, crude oil spot prices had risen by about 18 cents per gallon, while average retail gasoline prices had not risen at all according to the Lundberg Survey. Since crude oil costs are reflected in product prices over time, it was expected that gasoline prices would soon show additional increases. The supply uncertainty in the aftermath of the spill thus affected the timing of the price moves, but did not cause them.*

II. THE PERIOD UP TO MARCH 24: *Crude oil prices in the first quarter of 1989 were unexpectedly strong, rising 18 cents per gallon between November 1988 and March 24, but retail prices did not follow.*

A. OPEC's factionalism and its high 4th quarter 1988 production had been expected to keep crude markets weak.

B. Market psychology was subsequently buoyed by upward revisions in world oil demand, North Sea production problems, OPEC's ability to agree on quotas and other matters at its November meeting, and its willingness to tolerate limited quota violations.

C. The crude price low point was October and November, just prior to the OPEC meeting--less than $13 per barrel for both West Texas Intermediate (WTI) in Cushing, OK, and for U.S. refiner acquisition cost.

D. WTI prices rose to $18-19 by mid-January. On the day *before* the Exxon Valdez spill, they were quoted at over $20 per barrel.

E. The crude price increase between November and March 23 was $7.50/Bbl --18 cents per gallon.

F. Retail prices always follow significant changes in crude oil costs because crude oil cost represents 50-60% of the retail price of gasoline excluding the tax, but they follow with a lag. In November 1988, the gasoline price had been about the same as on March 17, the last Lundberg Survey before the spill. (In fact, gasoline prices had dipped in the interim, an indication of the lag.) The same pattern is evident in the weekly ex-tax retail price survey of the *Oil & Gas Journal*.

(fig. I)

G. Wholesale gasoline prices, such as dealer tank wagon prices, began to increase in early March, rising about 3 cents per gallon by March 24. Barge prices for gasoline, one step closer to the refiner and a harbinger of changing market conditions, had risen 7 cents in New York Harbor between March 1 and the Valdez spill.

H. The general market expectation on the eve of the Alaskan oil spill was that crude oil prices had peaked and would likely weaken somewhat in April, while gasoline retail prices would rise significantly, reflecting the increased wholesale costs.

I. The West Coast is a special situation: prices had begun to climb well before March 24, as shown in the accompanying charts. In fact, they show a markedly different pattern from the U.S. average.

(fig. II and III)

1. For instance, Los Angeles dealer tank wagon prices fell 7 cents per gallon between mid-November and mid-January, and then moved up by 16 cents between mid-February and March 23. On balance, however, the dealer tank wagon price still only gained 9 cents on the November base by the time of the Alaskan spill, or about half of the crude oil price increase over the period.
2. West Coast retail prices for unleaded gasoline also declined between November and January and then rose by about 6.5 cents to just before the Alaskan oil spill.

II. AFTER MARCH 24: *Wholesale markets reacted quickly to supply uncertainty, and retailers began to raise their prices to reflect increased costs.*

A. The Alaskan oil spill temporarily curtailed supplies. Since PAD V receives about 60% of its crude oil from Alaska (about 1.5 million barrels daily) and another 400 - 500 thousand barrels per day goes to the U.S. Gulf Coast, uncertainty over the duration and volume of the curtailment and announcements of *force majeure* by two major oil

companies brought on fears of shortages. The loss of Alaskan crude totaled some 13 million barrels.

B. For a number of reasons, all of them preceding the accident, gasoline markets were expected to be somewhat tight in 1989.
   1. Demand is expected to increase.
   2. Sophisticated downstream refinery equipment for gasoline manufacture is close to full utilization.
   3. Tighter volatility standards carry a significant volume penalty, perhaps as much as 150 thousand B/D, and uncertainty over RVP policy has stymied efforts to prepare.

C. Wholesale markets are mature, active, relatively transparent and include a large number of players. Trade publications and electronic reporting services provide rapid reporting of price changes. The New York Mercantile Exchange's gasoline contract provides information and flexibility to the market and in times of rapid changes, may accelerate the move.

D. Dealer tank wagon prices, on average, according to *The Oil Daily*, have risen 9 cents since March 24. Barge prices in New York Harbor rose 6 between March 24 and April 7.

E. Retail prices, according to the Lundberg Survey, rose on average about 10.9 cents between March 17 and April 7, the expected response to wholesale price increases.

IV. RETAIL MARKETS: *Many thousands of retailers set pump prices in this highly competitive market; large integrated refiners do not set prices at most retail service stations.*

A. Companies only set prices at stations they operate; independent dealers, who account for the vast bulk of retail outlets, set their own prices. According to the Department of Energy's data on major energy producers (the "FRS" series), the 22 reporting companies operated 16% of the stations they sold through.

B. The retail market, with some 150,000 outlets, is highly competitive, and competitive pressures are very localized, in particular in the very short term. Prices do not move up or down in a given area just because prices in a distant market have moved. When their wholesale prices begin to move, however, retailers of course try to pass these costs on.

C. Over time, retail prices must follow the cost of crude oil, its raw material, as noted earlier. The relationship functions in both directions, as shown in the accompanying chart. In 1986, crude oil prices (WTI spot prices at Cushing) fell by 26 cents per gallon and retail motor gasoline fell by 32 cents. December 1988 crude prices were 25 cents lower than the December 1985 level; gasoline prices over the same period were down 27 cents. Between December 1988 and the average March 1989 prices, crude oil has risen 7.3 cents while gasoline has risen about half that amount.

(fig. IV)

D. While crude oil costs inevitably affect the price of gasoline as well as that of all other refined products, each these products operates in its own separate market. Supply and demand factors and expectations as well as extraneous influences set the price in each of these markets.

V. A FINAL NOTE: *What we have seen is a market adjusting, both to cost factors set in motion months before, and to a temporary disruption. As before, if prices run up too far, they will correct to a lower level because demand will respond and so will supply, both foreign and domestic. In any case, for the last three weeks, the U.S. oil market has been reacting to unexpected extraneous events of brief duration but potentially serious. It will take a little while before the market returns to its natural equilibrium. When it does the real impact of the Valdez oil spill on U.S. gasoline prices can be properly assessed.*

Figure I

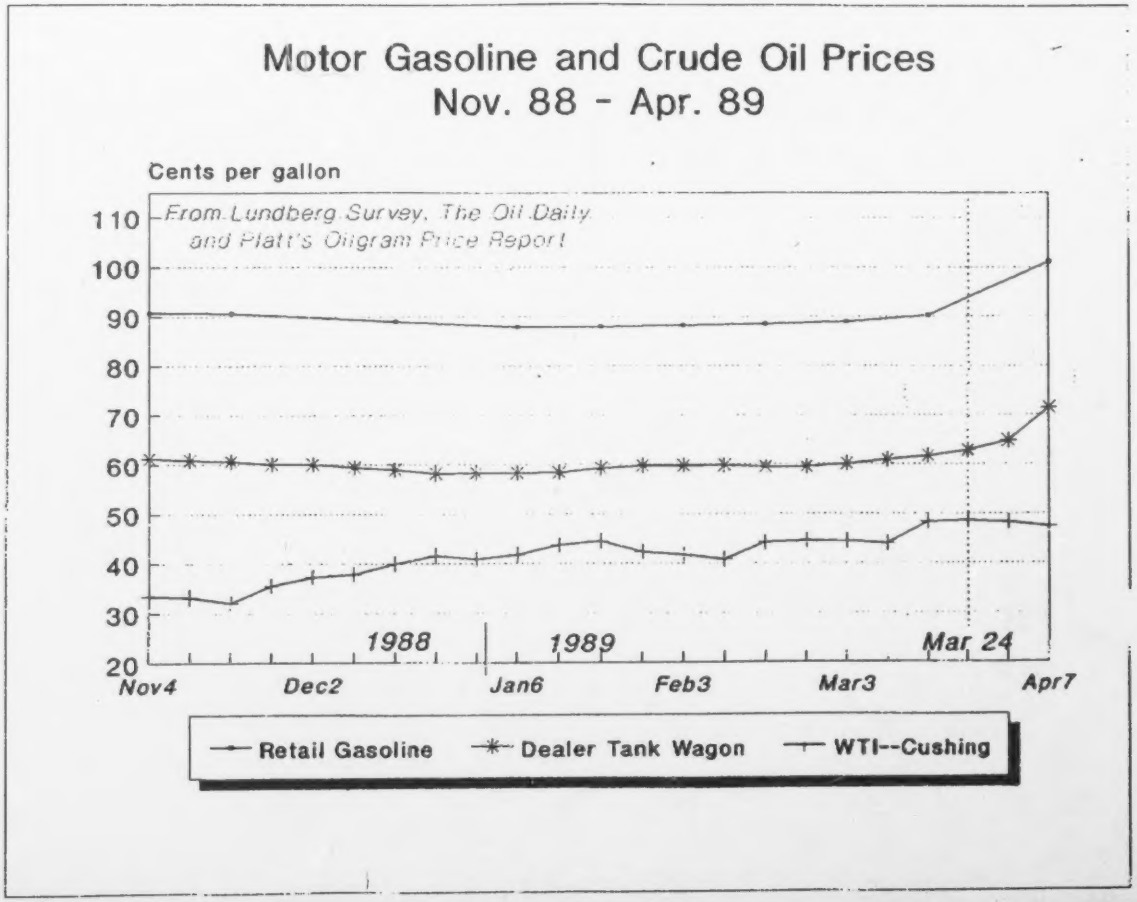

Motor Gasoline and Crude Oil Prices
Nov. 88 - Apr. 89
Cents per gallon
From Lundberg Survey, The Oil Daily and Platt's Oilgram Price Report
110
100
90
80
70
60
50
40
30
20
1988
1989
Mar 24
Nov4
Dec2
Jan6
Feb3
Mar3
Apr7
Retail Gasoline
Dealer Tank Wagon
WTI--Cushing

Figure II

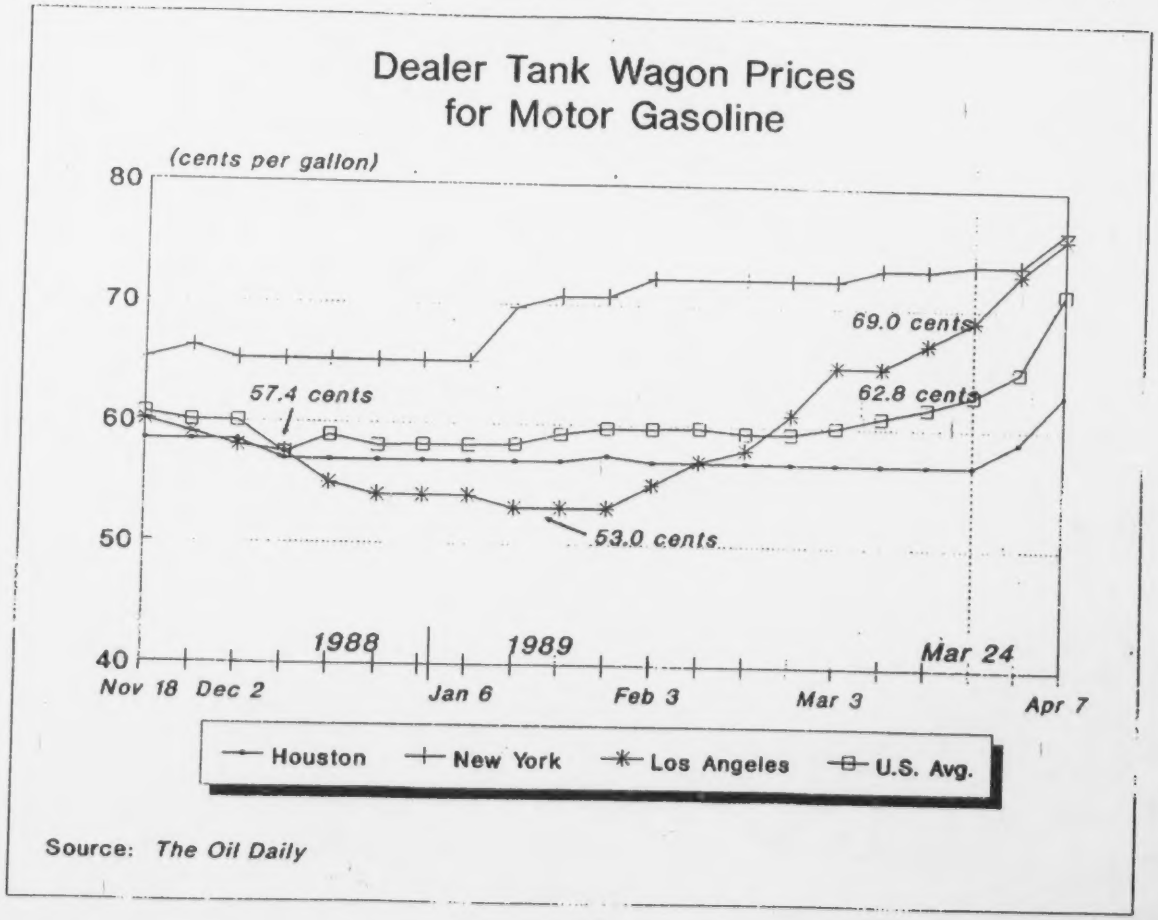

Dealer Tank Wagon Prices
for Motor Gasoline
(cents per gallon)
80
70
60
50
40
69.0 cents
62.8 cents
57.4 cents
53.0 cents
1988
1989
Mar 24
Nov 18
Dec 2
Jan 6
Feb 3
Mar 3
Apr 7
Houston
New York
Los Angeles
U.S. Avg.
Source: The Oil Daily

Figure III

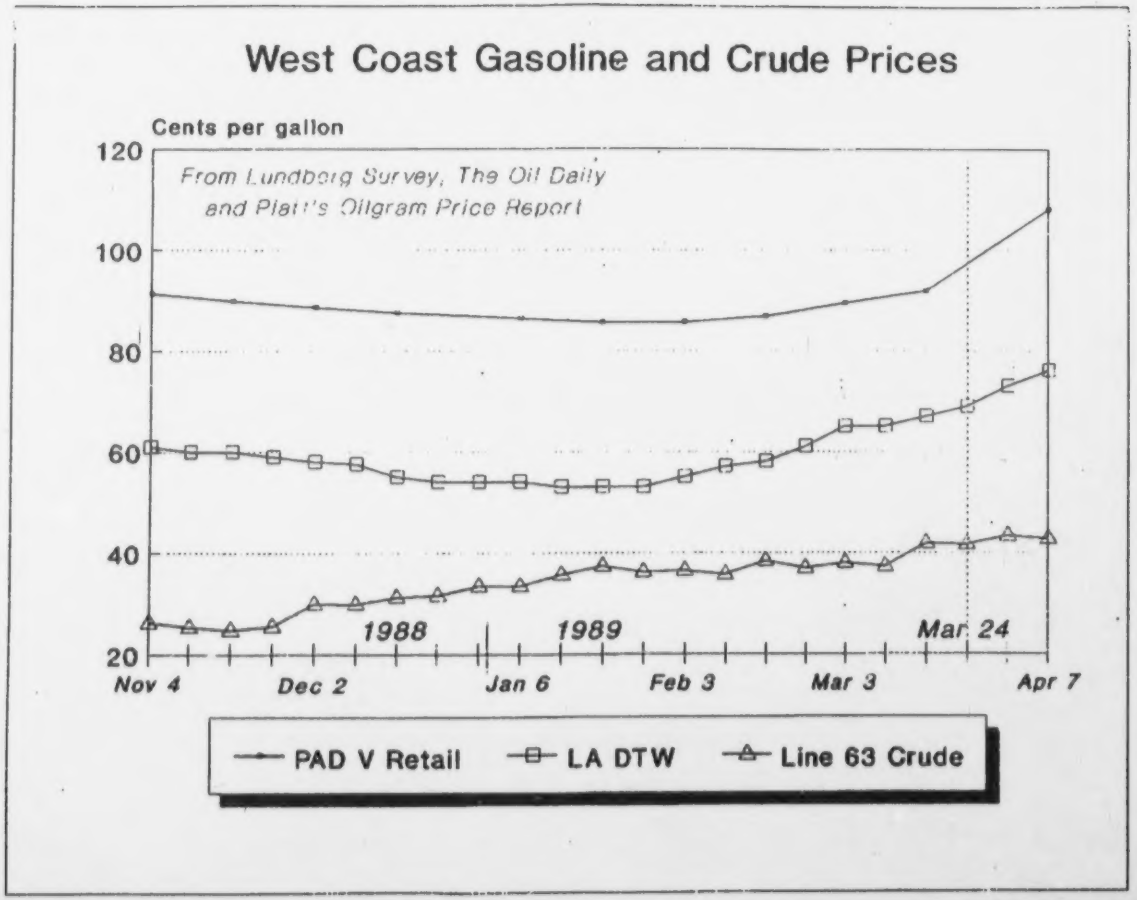
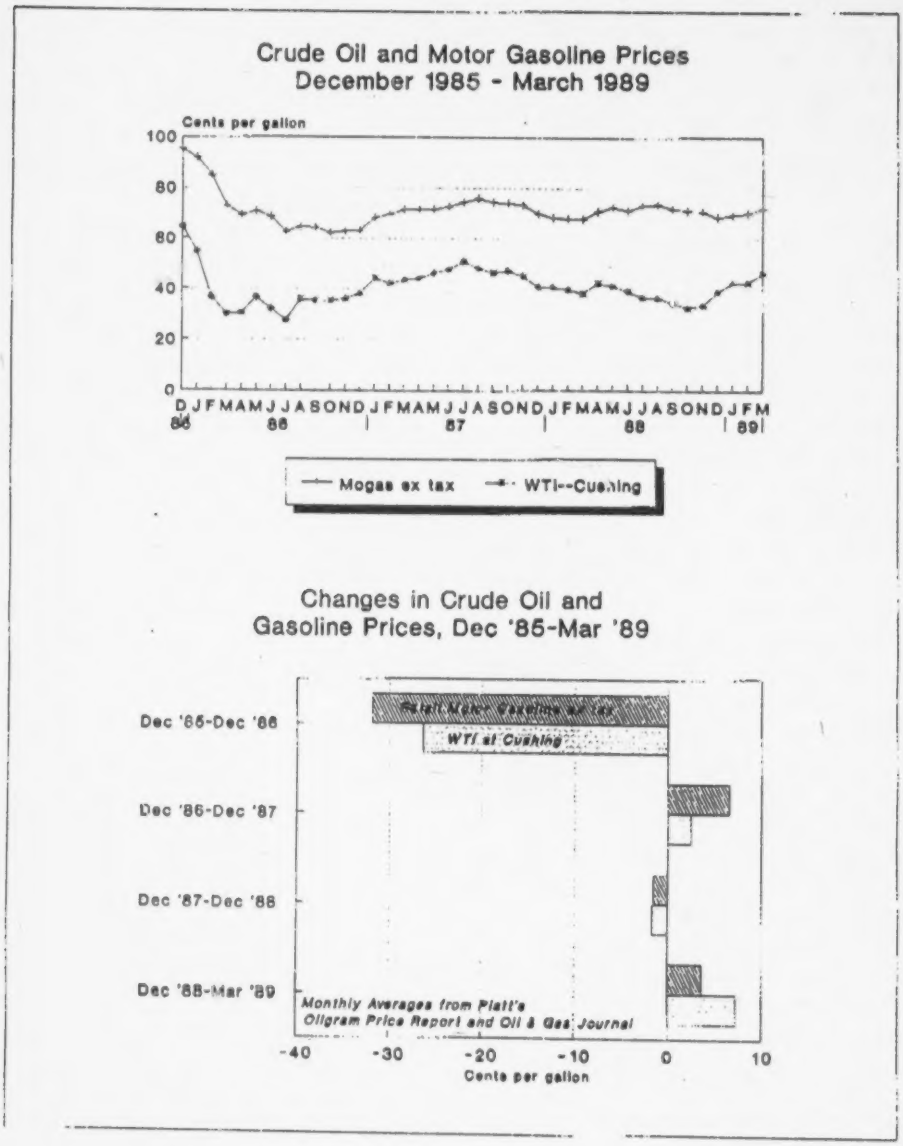

West Coast Gasoline and Crude Prices
Cents per gallon
From Lundberg Survey, The Oil Daily and Platt's Oilgram Price Report
120
100
80
60
40
20
1988
1989
Mar 24
Nov 4
Dec 2
Jan 6
Feb 3
Mar 3
Apr 7
PAD V Retail
LA DTW
Line 63 Crude

Figure IV


Crude Oil and Motor Gasoline Prices
December 1985 - March 1989
Cents per gallon
100
80
60
40
20
0
D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M
85
86
87
88
89
Mogas ex tax
WTI--Cushing
Changes in Crude Oil and
Gasoline Prices, Dec '85-Mar '89
Dec '85-Dec '86
Dec '86-Dec '87
Dec '87-Dec '88
Dec '88-Mar '89
WTI at Cushing
Monthly Averages from Platt's
Oilgram Price Report and Oil & Gas Journal
-40
-30
-20
-10
0
10
Cents per gallon

Senator METZENBAUM. No, the answer is no.

Mr. LICHTBLAU. Okay. Thank you.

Senator METZENBAUM. Thank you very much. I will come back to you with questions, Mr. Lichtblau. We do appreciate your testimony very much, and I did not mean to be flippant with you.

Mr. LICHTBLAU. No, I understand.

Senator METZENBAUM. Mr. Edwin Rothschild, Assistant Director of the Citizen/Labor Energy Coalition.

STATEMENT OF EDWIN S. ROTHSCHILD, ASSISTANT DIRECTOR, CITIZEN/LABOR ENERGY COALITION

Mr. ROTHSCHILD. Thank you, Mr. Chairman. We do appreciate the opportunity to testify. We hope that the full statement will be included in the record, and we also very much appreciate your holding hearings on this very important topic.

We agree that to some extent gasoline prices were on their way up before the Valdez incident. But the fact is that gasoline prices have shot up higher and faster after the disaster than can be explained by simple references to rising crude prices or any other cost factors.

I think we have to look at a longer term view. We cannot simply go back to October 1988, when the Department of Energy would like us to look. We have to look back further and we have to look at the changes in the way the industry is structured and has become reorganized.

And I think you used the word "oligopolistic" to suggest the way oil companies operate.

Senator METZENBAUM. I may have used the word. I could not pronounce it. [Laughter.]

Mr. ROTHSCHILD. A shared monopoly.

They have become far more entrenched, far more consolidated, far more concentrated, because of mergers, acquisitions, buyouts, regional pullouts, exchanges of gasoline in one area for a refinery in another. These kinds of activity have led to less competition.

So what you find if you go back to 1986 and 1988—and I am not even saying this. This is from the April 10th issue of Petroleum Intelligence Weekly, a well-known industry publication, and they say:

> Final consumers got virtually no benefit from last year's—

That is 1988—

> crude oil price decline. Instead, oil company downstream margins and government treasuries reaped most of the gain. Similar results occurred in 1986, when final consumers received only half of the gains from the collapse in oil prices and refiner margins increased substantially.
>
> The ability of refiners to capture most of the spread between crude oil feed prices and final retail levels enabled the downstream sector to reach record profit levels in 1987 and 1988.

What this points to, Mr. Chairman, is the fact that when crude prices come down consumers do not see any lower gasoline prices. And there is a chart in our testimony that shows the sharp increase in refiner margins in 1988 compared to 1987. I think you will find a similar chart for 1989 when we get all the data.

This data is taken from the Department of Energy.

Senator METZENBAUM. As I understand the point you are making, and you are basing it on information drawn from an unbiased source, the Petroleum Intelligence Weekly, that when wholesale prices went down the consumers did not pay a lesser price?

Mr. ROTHSCHILD. That is correct.

Senator METZENBAUM. But when wholesale prices went up, they not only paid a higher price, but they paid a substantially higher price, and more than the rate of increase. Do I understand you correctly?

Mr. ROTHSCHILD. That is correct, and that is known as the "refiner always wins rule." That is, when crude prices go up gasoline prices go up; when crude prices come down, gasoline prices do not come down.

The other quote I would like to—none of this is mine. This is from the Federal Reserve Bank of San Francisco analysis in December of 1988, saying the following:

> The evidence suggests that changes in the competitive market at the refinery level may make gasoline prices less sensitive to changes in crude oil prices. In particular, total refinery capacity has fallen in recent years. Moreover, a spate of mergers and acquisitions within the industry has decreased the number of producers and increased the level of industry concentration.
>
> These developments have effectively reduced competition in the production of gasoline products. Reduced competition in turn insulates gasoline prices from changes in crude oil prices, allowing refiners to boost profit margins when crude oil costs fall.

I would like to also answer Senator Johnston's I think very important question about regional disparities. I think the regional disparities are not explained, like Exxon's spokesman said, by taxes, because when you look at prices excluding taxes there are still huge disparities.

This is from the week ending April 5th, from the Oil and Gas Journal of April 10th. Houston had a price of 67.2 cents a gallon and Portland had 92.3. That is like 25 cents. But Omaha, which is not on the West Coast, had an 85 cent price. So there are huge disparities.

I suggest that there can probably be more explained by the level of competition in the market than anything else. I think Exxon spokesmen speak and spoke glibly about all this competition in the market and all these gasoline dealers. Well, if you look at the facts, there are fewer refiners serving that market. There are fewer refiners competing for that market.

You can quote William Randol, a New York investment analyst with First Boston, who says you can drive from New York City to Cape Cod, not leaving the major highways, and you will only find Mobil gasoline stations. They dominate the market, they set the prices.

And I think that, Mr. Chairman, is the underlying problem with this price increase. You had an underlying tight situation, you had this incident, and all of a sudden because of the lack of competition you had prices increase dramatically.

It also explains why, when crude prices fall consumers do not get the benefit.

I would also like to answer the question that Senator Johnston posed to the Exxon spokesman about whether gasoline prices will increase. Certainly they are going to increase, because they are going to follow the increase at the wholesale level that occurred, not in the spot market, but in the wholesale prices that refiners set, the refiner rack price and the refiner dealer tankwagon price.

The dealer is going to pass that along. They have no choice. Their margins stay fairly stable over time. They are not the ones that are profiting by this. It is primarily the refiners, and you can see that in their margins.

You can see that in their annual reports. You can pick out any annual report and they say: Wow, we had a wonderful year in 1988, we had the best year we ever had in our refining and marketing, margins were great, and we expect 1989 to be just the same.

And I will not be surprised if they are right, if they keep gasoline prices up the way they have already.

[The prepared statement of Mr. Rothschild follows:]

Statement

of

Edwin S. Rothschild
Assistant Director
Citizen/Labor Energy Coalition

on

Rising Gasoline Prices

before the

Subcommittee on Energy Regulation and Conservation

of the

Committee on Energy and Natural Resources

U.S. Senate

April 17, 1989

Summary

When the oil tanker Exxon Valdez ran aground on Bligh Reef on March 24, the average price of unleaded regular gasoline was about 95 cents per gallon. Three weeks later, the same gallon of regular unleaded gasoline costs 10c/per gallon more with further increases still in store for consumers.

The Exxon Valdez spewed 240,000 barrels of crude oil into Prince William Sound, less than 2% of daily U.S. requirements. As a result of the oil spill disaster tanker traffic out of Valdez was reduced temporarily and Alaskan oil producers, particularly Exxon and BP, declared *force majeur* in their crude oil supply contracts. In response, customers of Exxon and BP had to scramble to locate alternative sources of crude oil to feed their refineries.

The Exxon Valdez oil spill also led to a psychology of panic buying and panic bidding in the futures and spot oil markets. Spot prices for gasoline shot up as did spot prices for crude oil. These increases were quickly followed by increases for gasoline purchased at oil refinery and pipeline terminals, which in turn are being passed through by gasoline dealers as higher pump prices for consumers.

Many industry spokesmen and some analysts claim that higher retail gasoline prices are the result of market conditions -- tight gasoline supplies, higher crude oil costs, more stringent EPA Reid Vapor Pressure standards, increasing demand for high octane gasoline -- not an effort by major oil companies to seize the Alaska spill as an opportunity to increase their profit margins.

Mr. Chairman, it is our view, that while there is some merit to the argument that gasoline prices were already on the way up before the Exxon Valdez hit Bligh Reef, the facts indicate that gasoline prices shot up higher and faster after the disaster than can be explained simply by reference to market factors.

Oil company efforts to increase gasoline prices and profits are not a new phenomenon. Ever since 1986, major oil companies have been increasing and using their market power to expand refining/marketing profits. During period of falling crude oil prices in 1986 and again in 1988, major oil companies passed through to consumers only a small portion of the overall crude oil price decrease. This is due, in large part, to the growing concentration and consolidation within the industry. Mergers, acquisitions, exchanges, regional pullouts, and other forms of restructuring have reduced competition. A few large companies now dominate most regional gasoline markets and can often dictate prices.

At the same time that the major companies have reduced competition, they have also engaged in an octane race. In this race, the major companies have continued to increase octane ratings for their premium unleaded gasoline and have spent millions of dollars in high intensity advertising to create increased demand for their most profitable product. The increased production of high octane gasoline not only reduces the overall amount of gasoline produced, but increases U.S. dependence on foreign crude oil, because it takes more crude oil to make a gallon of high octane gasoline.

Mr. Chairman, we believe that the domestic gasoline market is far less competitive today than it was five years ago. Something must be done. It is clear that the Department of Justice's Antitrust Division, the Federal Trade Commission, and the Department of Energy believe that the marketplace is working just fine, that the restructuring of the industry has been beneficial and that consumers need not worry. This viewpoint is not surprising. It does, however, demonstrate that consumers should not look to these agencies for help. It is also clear that oil companies will not voluntarily roll back their prices. They are not social service agencies. If the marketplace and the antitrust authorities cannot be called on to police anticompetitive problems, then Congress must act. A major antitrust investigation is called for and if findings of such an investigation indicate serious anticompetitive problems, then Congress must legislate remedies.

These remedies can extend from divestiture to the imposition of far more stringent CAFE standards, from promotion of clean-burning renewable fuels, to increase in the gas guzzler tax. Promoting fuel conservation and energy efficiency will not only reduce import dependence, but could once again create a surplus of refining capacity, which could in turn lead to more competition.

Mr. Chairman and members of the committee, my name is Edwin S. Rothschild and I am the assistant director of the Citizen/Labor Energy Coalition. I very much appreciate the opportunity to testify today on the issue of rising gasoline prices.

The Oil Spill and its Aftermath

On March 24 the tanker Exxon Valdez ran aground and started spilling 240,000 barrels of crude oil into Prince William Sound. This disaster also slowed down deliveries of crude oil from the port of Valdez and moved Exxon and BP to trigger *force majeur* provisions in their crude oil contracts (Exxon's *force majeur* declaration may very well have been illegal since they caused the spill through negligence). It has been reported that a total of 12 million barrels of Alaskan oil was not delivered to market during the 11 days following the oil spill.[1] It was also reported that U.S. crude oil stocks were drawn down by 12 million barrels over the same period and that refiners cut off from Alaskan crude supplies had to scramble for alternatives. Most refiners did not report any serious problems[2], although some did report that there had been runs on gasoline stocks, especially in California. Data from the Energy Information Administration indicates that gasoline inventories in California were indeed drawn down quickly between March 24 and April 7 (See Figure 1 below).

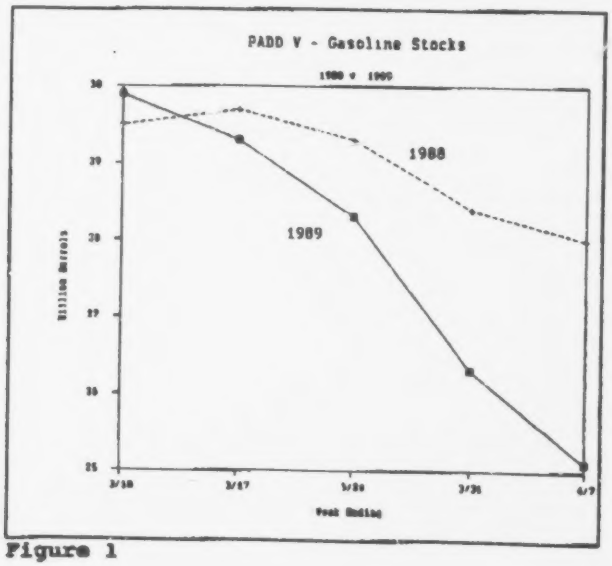


Figure 1

Gasoline inventories also declined nationwide (See Figure 2.)

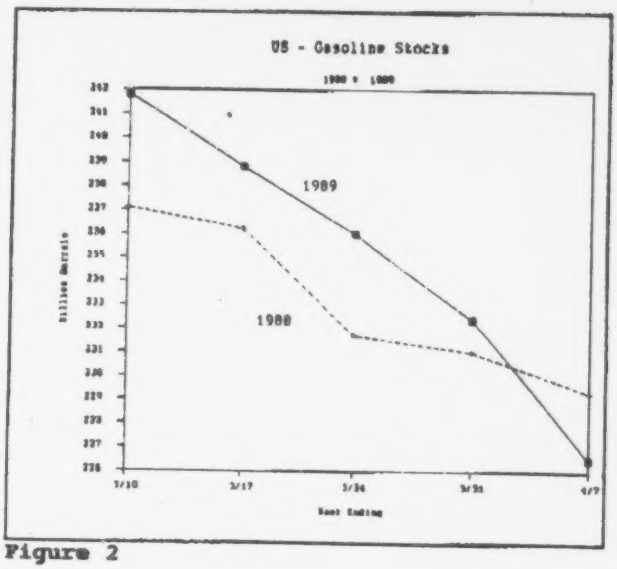


Figure 2

The panic buying of gasoline by wholesalers and the panic on the spot and futures markets contributed to psychology of shortage even though crude oil supplies were sufficient and even though refiners were capable of meeting demand for gasoline products.

With spot and futures prices skyrocketing, refiners began to increase their own wholesale prices – refinery rack or terminal prices and DTW (Dealer Tankwagon) prices. In most U.S. markets, major refiners increased their wholesale prices by about 10 cents per gallon. In Los Angeles, where there was far more panic buying than anywhere else, prices went up by as much as 30 cents a gallon. An indication of how companies and markets not affected by the cutback in Alaskan crude responded in a fashion similar to companies on the West Coast is demonstrated by the sharp price increases in places like Indianapolis and Chicago.

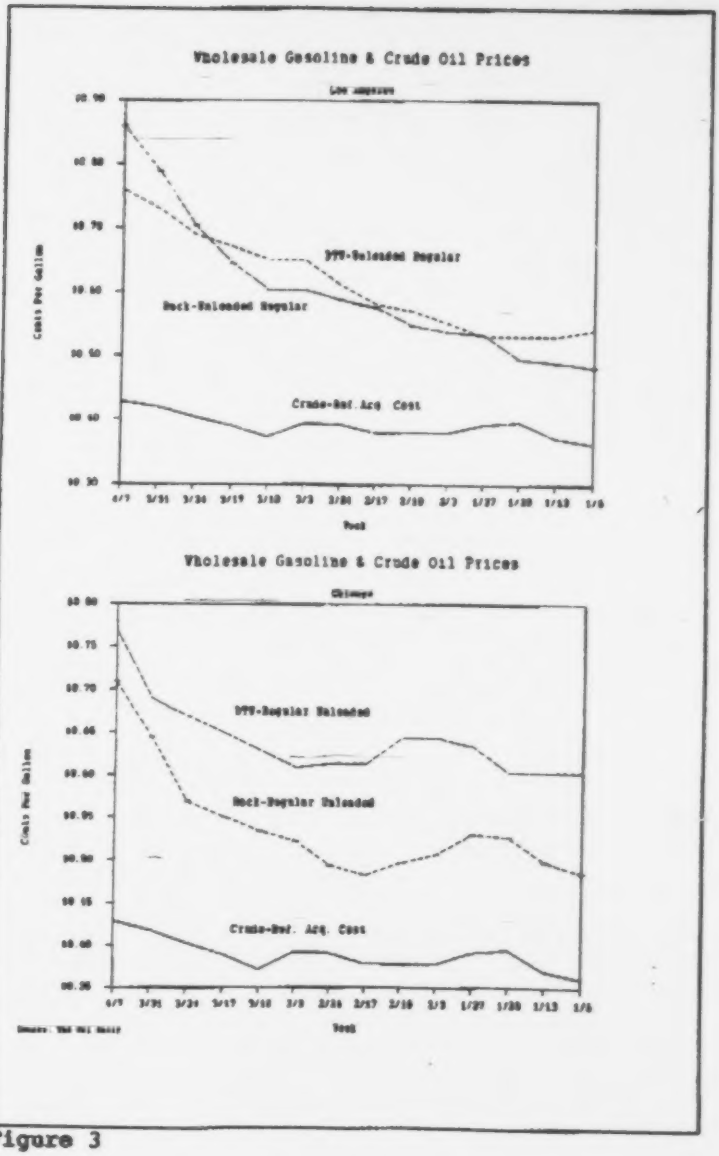
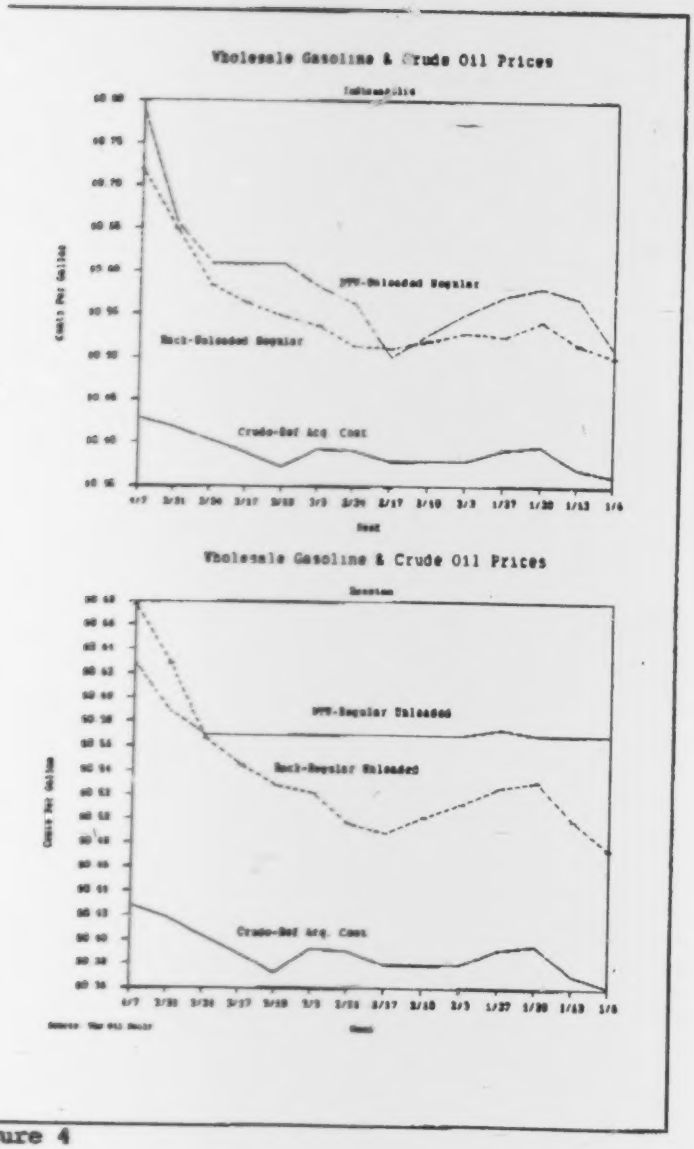

Wholesale Gasoline & Crude Oil Prices
Los Angeles
Cents Per Gallon
DTW-Unleaded Regular
Rack-Unleaded Regular
Crude-Ref.Acq Cost
Week
Wholesale Gasoline & Crude Oil Prices
Chicago
Cents Per Gallon
DTW-Regular Unleaded
Rack-Regular Unleaded
Crude-Ref. Acq. Cost
Week

Figure 3


Wholesale Gasoline & Crude Oil Prices
PPP-Unleaded Regular
Rack-Unleaded Regular
Crude-Ref Acq. Cost
Wholesale Gasoline & Crude Oil Prices
PPP-Regular Unleaded
Rack-Regular Unleaded
Crude-Ref Acq. Cost

gure 4

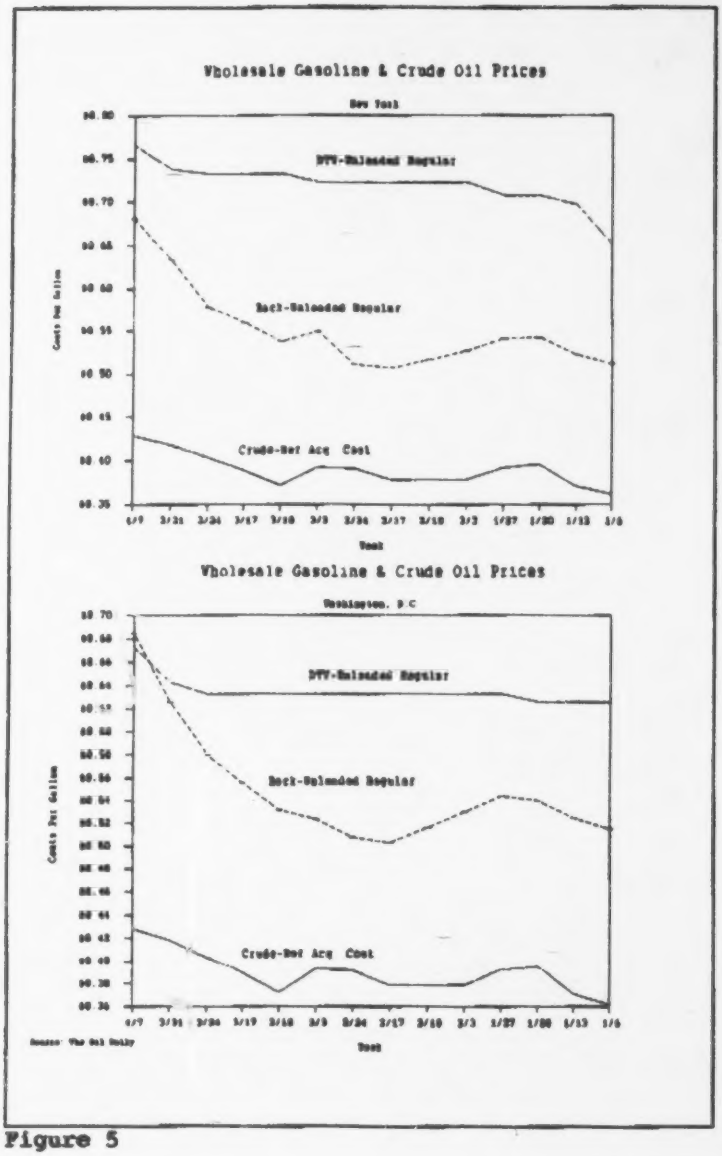

Wholesale Gasoline & Crude Oil Prices
DTY-Unleaded Regular
Rack-Unleaded Regular
Crude-Dst Acq Cost
Wholesale Gasoline & Crude Oil Prices
DTY-Unleaded Regular
Rack-Unleaded Regular
Crude-Dst Acq Cost

Figure 5

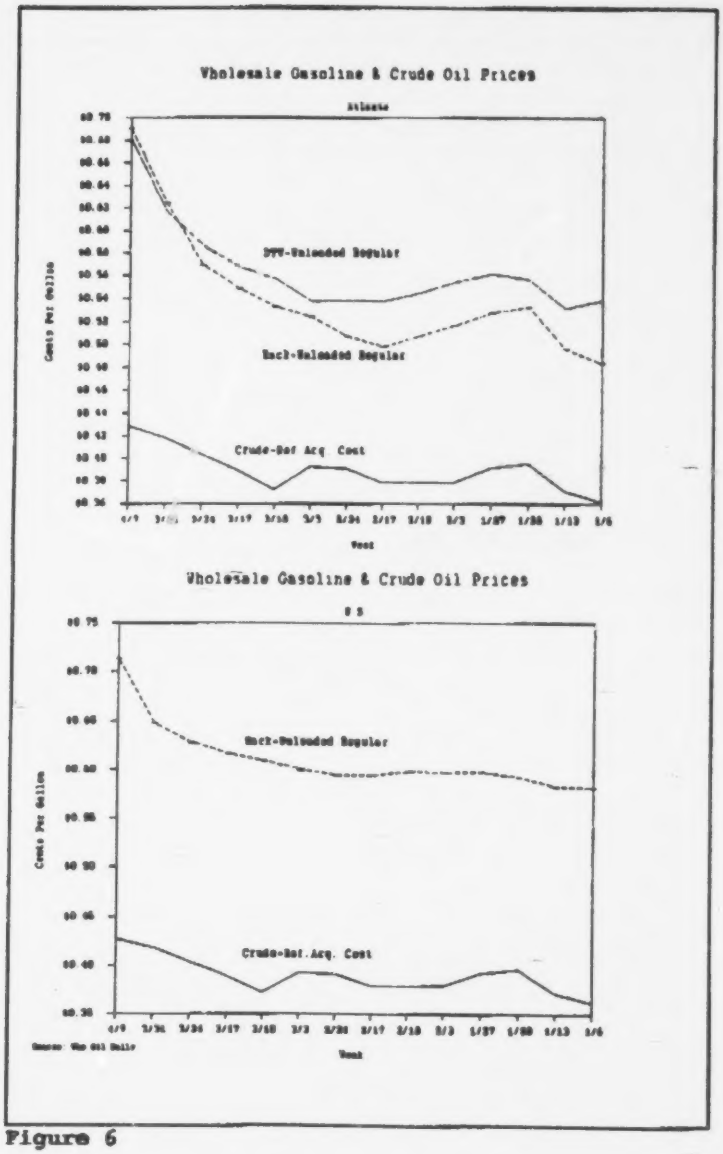

Wholesale Gasoline & Crude Oil Prices
Atlanta
DTW-Unleaded Regular
Rack-Unleaded Regular
Crude-Ref Acq Cost
Cents Per Gallon
Week
Wholesale Gasoline & Crude Oil Prices
U S
Rack-Unleaded Regular
Crude-Ref.Acq. Cost
Cents Per Gallon
Week

Figure 6

The graphs indicate that gasoline prices began to rise before the spill. In California, several factors helped push gasoline prices higher. Maintenance at several refineries took longer than anticipated and crude price increases were being passed through by refiners. In addition, refiners also were raising prices for new supplies of lower-volatility gasoline required by the EPA. There is little doubt, however, that the oil spill allowed many refiners to raise prices faster and higher than they would have.

The basic motivation for these price increases have more to do with an effort to maintain and/or increase profits on the sale of gasoline than anything else.

Lessons From History

Over the last few years, major oil companies have shifted their strategy and their profit centers. They no longer seek to earn the bulk of their profits on the production of crude oil and natural gas, but are also seeking to maximize profits on their downstream segments -- refining and marketing. In 1986 and again in 1988, major oil companies sharply increased their refining and marketing profits by not passing through to consumers the full decline in crude oil prices. This finding was recently confirmed by the highly regarded *Petroleum Intelligence Weekly* (April 10, 1989),

> Final consumers got virtually no benefit from last year's crude oil price decline. Instead, oil company downstream margins and government treasuries reaped most of the gain. Similar results occurred in 1986, when final consumers received only half of the gains from the collapse in oil prices and refiner margins increased substantially. The ability of refiners to capture most of the spread between crude feed prices and final retail levels enabled the downstream sector to reach record profit levels in 1987 and 1988.

In our study, "The 1988 Gasoline Squeeze," published last August, we published data on this very issue. We have updated some of this data in the figures below.

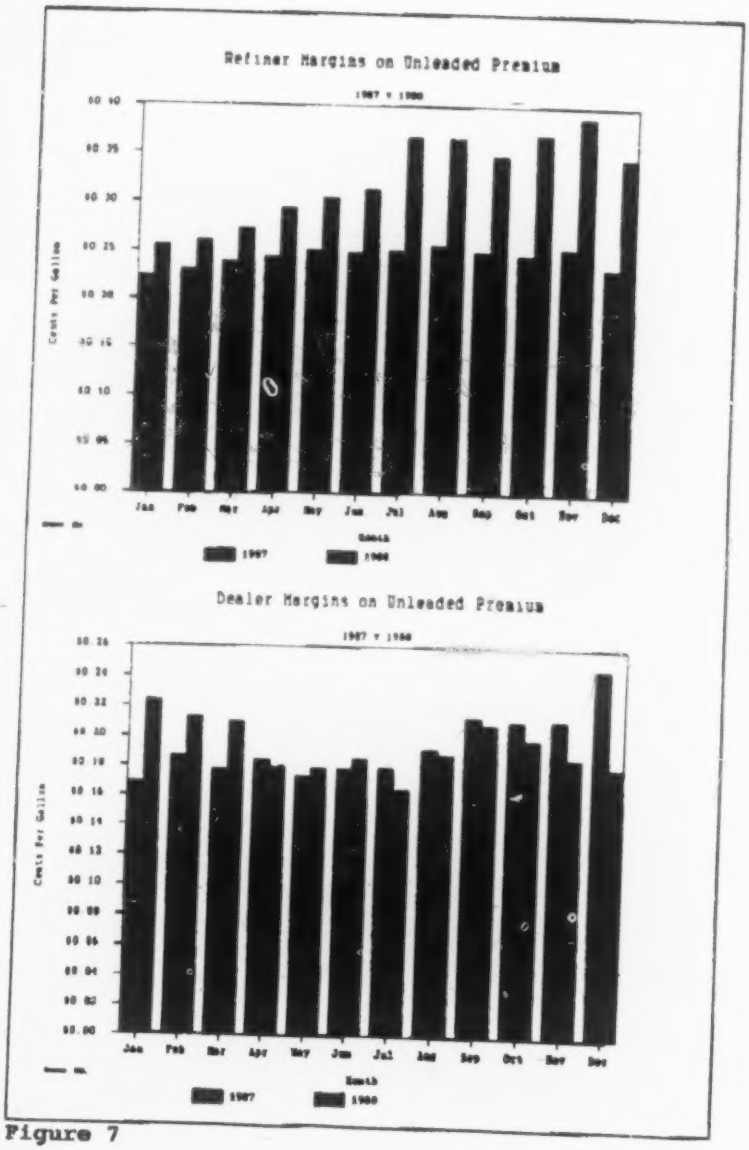

Refiner Margins on Unleaded Premium
Dealer Margins on Unleaded Premium
Cents Per Gallon
Month
1987
1988

Figure 7

These graphs clearly demonstrate that refiner margins grew substantially in 1988. Thus, while crude oil prices fell, gasoline prices remained high. Under ordinary circumstances, we are told by those in the industry, especially the American Petroleum Institute, that there is a lag effect when crude prices fall, that it sometimes takes a month or two before consumers see lower prices at the pumps. But this did not happen.

The industry likes to have the argument both ways. When crude oil prices rise, refiners must quickly raise prices for gasoline to "reflect higher crude costs." This sounds like the refiner always wins rule. When crude prices fall, we have to increase our margins. When crude prices rise, we have to pass through the increases to maintain our margins. Somehow the issue of competition among refiners is a question neither the industry nor the administration is able to confront.

Market Structure and Rising Gasoline Prices

Underlying the recent skyrocketing pump prices for gasoline and last year's soaring profits from refining and marketing (See Table I below), one must come face to face with the significant structural changes that have taken place in the U.S. oil industry.

Table I

After-Tax Operating Income
Refining & Marketing
(in millions $)

Company	1986	1987	1988
Exxon	478	32	672
Mobil	365	123	365
Texaco	138	-36	651
Chevron	640	117	571
Shell	319	224	519
Amoco	362	216	897
Arco	353	150	368
BP	640	259	456
Phillips	458	201	471
USX	352	187	485
Sun	208	57	286
Unocal	182	42	111
DuPont	414	177	363
Coastal	-3	43	169
Amerada Hess	-277	-19	139
Ashland	326	74	259
Pennzoil	167	116	111
Murphy	-6	-1	36
Am. Petrofina	-20	23	100
Tesoro	70	31	66
Crown Central	-20	32	38
Total	5146	2048	7133

Source: Company Annual Reports

Of profound importance to the pricing of gasoline is the degree of competition at the wholesale and retail level. Over the last few years major oil companies through acquisitions, mergers, and market consolidation have sharply reduced the number of wholesale and retail suppliers of gasoline in major markets across the country.[3]

Over the last seven years, for example, 117 refineries were shut down. This reduced the number of competitors overall, but more importantly reduced supplies to independent gasoline wholesalers and retailers, the most competitive segment of the marketplace.[4] At the same time, major oil companies concluded significant mergers which effectively eliminated competitors from the marketplace. Among these mergers are: Chevron/Gulf, Texaco/Getty, and BP/Sohio, as well as the recent sale of Tenneco's refining assets to Mobil and Atlantic Refining to Sun.

The largest oil companies in the country control about 80% of the nation's refining capacity and about the same percentage of gasoline output.[5] The ability of major oil companies to keep gasoline prices high is related to not only the decline in the number of refiners in the United States via mergers and acquisitions, but also to the drop in overall refinery capacity.

> The evidence suggests that changes in the competitive environment at the refinery level may make gasoline prices less sensitive to changes in crude oil prices. In particular, total refinery capacity has fallen in recent years. Moreover, a spate of mergers and acquisitions within the industry has decreased the number of producers and increased the level of industry concentration. These developments have effectively reduced competition in the production of gasoline products. Reduced competition, in turn, insulates gasoline prices from changes in crude oil prices, allowing refiners to boost profit margins when crude oil costs fall.[6]

Table II

SHARE OF THE NATIONAL GASOLINE MARKET

Company Share	1987 % Mkt. Share	1986 % Mkt. Share	1985 % Mkt.
Shell	9.5	8.7	7.3
Chevron	8.3	8.4	8.7
Texaco	7.7	8.0	7.9
Exxon	7.5	7.5	7.6
Top 4	33.0	32.6	31.5
Amoco	7.2	7.4	7.2
Mobil	7.1	6.7	6.1
BP (Sohio)	5.6	5.0	4.9
Arco	4.7	4.6	4.3
Top 8	57.6	56.3	54.0
Top 15	82.7	76.6	73.1

Source: National Petroleum News Factbook Issue, 1988 and 1987 editions.

On a regional basis, however, these percentages are much higher. Fewer companies control larger shares of the market.[7] Gasoline produced in one area of the country is rarely sold in another area. Gasoline produced on the West Coast, for example, is not sold on the East Coast and vice versa. Because the U.S. gasoline market is organized on a regional basis, between four and eight refiners usually dominate a regional or local market.

The companies have also shut down operations in some areas of the country and expanded in others – all aimed at increasing market share and gaining control over pricing. In most major gasoline markets, especially those on the East Coast and West Coast, a small handful of companies are dominant. In 1984 (the most recent data available), for example, just four firms sold 53% of the gasoline in Philadelphia. Similarly, four firms sold 58% of the gasoline in Washington, D.C.[8], which perhaps explains why the Washington, D.C. metropolitan area tends to have the highest priced gasoline in the nation.

The San Francisco Federal Reserve Bank agrees and points out that recent mergers and acquisitions have led to greater concentration in regional markets. "As a consequence

of this regionalization," according to the analysis, "individual markets often have fewer suppliers, increasing the market power of the remaining participants." This may be the reason gasoline prices in New York hardly moved when prices fell and then rose. The few refiners in the market may have set the price and expected it to remain at a high level unless disturbed by a significant event. The Alaska spill was such an event, and so the very high New York prices are going even higher. This phenomenon was also explained by William Randol, the petroleum industry analyst with First Boston Corp., who wrote,

> If you drive from New York City to Cape Cod, staying on the major highways, you are forced to buy Mobil gasoline; there is no alternative. And you pay their price. The company that dominates the market can pretty well dictate the price structure.

With dominance over refining and marketing organized regionally, the major oil companies can easily take advantage of certain changes in the marketplace. These changes include things such as -- declining crude oil prices, a shift to unleaded fuels, and consumer attitudes, influenced by oil company advertising, toward high octane fuel.

Promoting Demand for High Octane Unleaded Gasoline

While overall gasoline demand has been increasing, the composition of gasoline sold has changed considerably. Regulations implemented by the Environmental Protection Agency require oil companies to reduce substantially the content of lead in automotive fuels. As a result, leaded fuel has continued to decline as a percentage of overall supply, while unleaded gasoline has increased. More importantly, the greatest increase in demand has occurred for premium unleaded gasoline.

Oil companies have not been taken by surprise by either the increase in total gasoline consumption, or the increase in unleaded demand. They have been well prepared for the changeover. Refiners have reconfigured their refining operations; have invested in expanding certain refining operations, and produce and/or purchase chemical additives to replace lead. Refiners have had no significant problems in manufacturing fairly inexpensive lead substitutes to provide the required amount of octane for regular and premium grades of gasoline. In fact, because the companies realized how easy it was to replace lead, they found themselves with a "surplus" of unleaded gasoline. This "octane surplus," as it is called in the industry, has, according to one highly regarded industry analyst,

> ...prompted many of the major gasoline producers to begin raising their premium product octanes further, in an effort to better the competition's products, and to provide some greater quality differentiation among their unleaded fuels (i.e., to provide a better niche for midgrade).[9]

And an oil industry executive, in an unguarded moment, made it quite clear that

demand for higher octane premium unleaded gasoline was being created not by consumer "demand," but by the industry's desire to eliminate a "surplus."

> Octane demand is a situation ***forced on customers*** as a marketing advantage over competitors because ***major companies have installed so much octane equipment.***[10] (Emphasis added)

One industry trade publication, in analyzing the companies rush to increase the octane level of premium unleaded gasoline, stated that "1987 and this year can be viewed as 'the years of the octane race.'"[11] To persuade consumers to buy higher octane premium unleaded gasoline, oil companies have to create the illusion that "more is better." Says, an executive for Sun Refining and Marketing Co.,

> ...Publicity about fuel injector plugging and additive packages will...foster premium sales [even though almost all unleaded fuels contain detergents to clean fuel injectors]. That's where the best additive packages are used, and more importantly, advertised. Finally, "selling the sizzle," i.e., selling what people want is as important as ever, and many consumers want premium.
>
> To enhance this perception of quality, the octane of premium is also going up.[12]

To create the perception of a difference and to stimulate demand, many large companies are producing increasingly higher levels of premium unleaded (from 91 to 93 octane) fuel and have been spending tens of millions of dollars in television and other advertising to persuade consumers to purchase their "new" and "better" premium unleaded gasoline products. Exxon has launched a major campaign to market its "Supreme," claiming it "provides high quality performance for the increasingly sophisticated engines of today's automobiles." Chevron's television ad promoting its "Supreme 93" features the owner of a 1955 Thunderbird who wants to "baby" his car with the best possible gasoline.

Amoco, for example, claims that its highest octane gasoline, "Ultimate," keeps an entire engine spotlessly clean, while "most gasolines" only keep fuel injectors clean. Of course, cleaning fuel injectors or engines has nothing to do with high octane and everything to do with the "detergent" package that companies add to their fuels. The fact is that almost all oil companies put detergent into their unleaded fuels to keep fuel injectors and other engine parts free of dirt.[13] But by combining the idea of a clean engine with its highest octane fuel, Amoco (and others) are saying to the public: "Buy premium gasoline to keep your car engine clean" -- a patently false claim.

And, of course, their advertising and promotion have had the desired effect. The demand for premium is rising more quickly than "overall gasoline demand."[14] Even though

most automobiles on the road today, which must use unleaded fuel, do not need the premium grades, many consumers have the mistaken belief that higher octane gasoline is better for their cars. Many fuel experts argue, however, the average car only needs a higher octane fuel, if the engine begins to knock. According to John Fobian, the director of the American Automobile Association's Automotive Engineering Department,

> ...don't look at the octane rating as a measure of the quality of the gas.[15]

Similarly, according to the American Petroleum Institute, the oil industry's principal trade association,

> In most vehicles, no benefit is gained from using gasoline that has a higher octane number than is needed to prevent knock.[16]

Otherwise, unless consumers drive automobiles with high compression engines (which require high octane fuel), the lower octane grades of 86-87 or the mid-grade 89 should be acceptable.[17] Oil companies are introducing the mid-grade as a substitute for regular leaded gasoline[18] -- a product with a lower margin of profit.[19]

Octane ratings reflect one thing -- the speed at which the fuel burns. The lower the octane, the faster the fuel burns. High octane fuel neither provides increased fuel mileage, nor improved cleansing properties. All unleaded grades of gasoline contain "detergents" which clean fuel injectors and other engine parts.

Automotive experts at the American Automobile Manufacturers Association say that 90% of the automobiles manufactured since 1982 do not require high octane unleaded gasoline. This premium grade, they say, should be used for those high compression engines found in cars like, Porsche, BMW, Mercedes Benz, and a handful of American car models.[20] However, they do point out that cars which are more than 5 or 6 years old may also need a higher octane to cure "knock."

By successfully increasing demand for their premium (the highest priced and most profitable gasoline grades, oil companies are insistent that they are doing everything they can to keep up with demand. This self-serving rationale has had a number of critical consequences.

> I. The processing of high octane gasoline reduces the total output of gasoline.
>
> II. With less gasoline available, prices remain high.

NOTES

1. "Exxon Valdez Refloated;TAPS Throughput Hits 2-Million B/D,"Platt's Oilgram News, April 6, 1989, p.1.

> "From March 24--the day of the oil spill--through April 3, Alyeska calculates that some 9.4 million bbl of Alaska North Slope crude has come down the pipeline. Assuming normal operating capacity of 2-million b/d, this means some 12.6 million bbl of crude has been lost in the first 11 days following the accident.

2. Ibid.,p.1.

> ...oil trading sources indicated that due to cutbacks inNorth Slope crude supply, Atlantic Richfield had cut refinery runs at its Richmond unit by some 20% and at El Segundo by at least 10%. An Arco spokesman denied the reports, saying the company was maintaining normal refinery operations at the California units, was meeting all product commitments and wasn't planning any cuts.

3. "Array of Forces Bolstering The Pump Price of Gasoline," The Wall Street Journal, July 11, 1988.

> ...With their lower costs and deeper pockets, the major companies have been gobbling up larger chunks of regional markets at a time when independent station owners and marketers are abandoning their businesses because of slim profit margins.

4. A recent example is Sun's acquisition of Atlantic Fuels, whose owner is independent oilman, John Deuss. The gobbling up of Atlantic by a large integrated domestic oil company means an end to aggressive competition in Northeast markets. As one trade publication reported, "Several competitors were said to be jumping for joy at the prospect of Atlantic no longer setting street and rack prices in the Pennsylvania/New York/New Jersey area. The company had a reputation for often setting dealer prices 3-5cts gal below the lowest competition."(Emphasis added) Quoted in Oil Price Information Service, July 11, 1988, p.4.

5. Performance Profiles of Major Energy Producers 1987, Energy Information Administration, Department of Energy, January 25, 1989.

6. "Crude Oil and the Price of Unleaded Gasoline," FRSBF Weekly Letter, Federal Reserve Bank of San Francisco, December 30, 1988.

7. Based on data provided by the Energy Information Administration and the Federal Trade Commission. See "The Great Gasoline Stick-Up," C/LEC Research Report, April 1986, pp. 13-16.

8. National Petroleum News Factbook, 1984.

9. "Projecting Future Gasoline Grade Market Shares," Charles L. McSpadden of Bonner and Moore Market Consultants, a presentation to the 1988 National Conference on Octane and Oxygenated Fuels, March 22-24, 1988.

10. Op. Cit., Oil & Gas Journal, p.15.

11. "Premium Unleaded Could Take 30% of Market by '92," The Oil Daily, March 21, 1988, p. 14.

12. "New Weapons Help Refiners to CLose the Octane Gap," Brian Davis, The Oil Daily, March 21, 1988, p.12.

13. "Gasoline for Your Car," American Petroleum Institute, April 1986, p.6.

> Detergent additives also help keep positive crankcase ventilation (PCV) valves, exhaust gas recirculation (EGR) valves, and other internal parts cleaner.

14. "Rising Octane Demand Puts U.S. Refiners In Supply Vise," Oil & Gas Journal, June 27, 1988, p.15.

15. "All About Octane," AAA World, July/August 1988, p.15.

16. Op.Cit., API, p.2.

17. Op.Cit., Oil & Gas Journal, p.17.

> All current GM models except the Cadillac Allante are designed to run on regular unleaded gasoline. That's also mostly true of other automakers.

18. "Mid-Grade Arrives on the Scene," Lundberg Letter, June 10, 1988, p.1.

19. "Product Demand Surge Keeps Leaner U.S. Downstream Humming," Oil & Gas Journal, March 30, 1987, p.53.

> Some are already offering an 89 octane mid-grade unleaded fuel to replace leaded regular grade because some refiners say that leaded gasoline at 0.1 g/gal is more expensive to produce than an 89 octane unleaded. (Emphasis added)

20. Op.Cit., The Oil Daily, March 21, 1988, p.14.

> The increased production of high performance automobiles and the 65 miles per hour speed limits on many highways will only serve to increase demand for high quality fuel. Already, cars produced by Mercedes Benz, Porsche and Peugot recommend the use of 91 or higher premium unleaded fuel for all models.

Senator METZENBAUM. Thank you very much, Mr. Rothschild.

Our next witness is Mr. Tracy Stanton of Bexley, Ohio, Past President of the Service Station Dealers of America. Mr. Stanton, we are very happy to have you with us.

STATEMENT OF TRACY L. STANTON, SHELL DEALER AND PAST PRESIDENT, SERVICE STATION DEALERS OF AMERICA, ACCOMPANIED BY JIM DASKAL, GENERAL COUNSEL, SERVICE STATION DEALERS OF AMERICA

Mr. STANTON. Thank you very much, Mr. Chairman. It is a pleasure to be here today. My name is Tracy Stanton. I am an independent gasoline dealer from the State of Ohio.

I would like to introduce this gentleman to my right, Mr. Chairman, Mr. Jim Daskal. He is General Counsel for the Service Station Dealers of America, and hopefully today he is going to keep me out of any additional trouble.

Senator METZENBAUM. Happy to have you with us, sir.

And I hope that Exxon does not get so upset with your testifying that they might see fit to take some action.

Mr. STANTON. Well, I am not with Exxon.

Senator METZENBAUM. Well then, they certainly will not. [Laughter.]

Mr. STANTON. As you said, Mr. Chairman, I am Past President of the Service Station Dealers of America. The trade association, together with its 43 state and regional affiliates, serves as the voice of America's 60,000 independent gasoline retailers.

I have operated Tracy's Shell Center in Bexley, Ohio, a suburb of Columbus, for the past 13 years. I have been a dealer for over 21 years.

Since the Valdez catastrophe—and I am not sure of the date because I have heard four dates here today. I thought I knew the date when I came here and now I am not certain. But since the Valdez catastrophe my dealer tankwagon, the wholesale price that I pay for gasoline, has gone up 11 cents a gallon.

My cost of gasoline has gone up 21 cents since March the 1st of this year. It has risen further and faster than any time in my history as a service station dealer. This includes both the 1973 embargo times and the 1979 shortages.

Service station dealers in this situation sort of feel like pawns in a giant chess game. We are the folks who must face the end user, the angry consumers, each week.

I have sought a straight answer as to why prices shot up faster than in previous shortages. I have heard more explanations than Baskin-Robbins has flavors. Everything from OPEC to environmental regulations has been blamed. The Service Station Dealers of America believe the answer is twofold: First, oil company greed; and the unprecedented control of the market by the major oil companies.

Unfortunately, the public has vented its frustration at dealers such as myself. Exxon stations have been shot at, vandalized, and picketed, and in Colorado dealers have received bomb threats.

The Committee and the American public must realize that the dealers are innocent victims, just as the oil-covered otters that they

see on TV. We have no control over the price of gasoline. In some cases, dealers have been able to buy the same brand of gasoline from a middleman distributor as much as 15 cents per gallon cheaper than they can purchase it directly from the oil company at wholesale tankwagon price.

Yet when we as dealers try to get these lower prices for our customers, we are threatened with termination of our franchises. For this reason, 19 Exxon dealers filed suit in Houston last week to stop the overcharging of the Texas public.

Not only does the dealer have no control over our wholesale costs, most of our costs of doing business are controlled by the oil companies. For example, many dealers are forced to stay open during hours which are unsafe and unprofitable. Rents at these stations are also under the control of big oil.

I say this carefully. Congress is partly to blame for this situation. The Petroleum Marketing Practices Act forces dealers to accept any contract provision the oil companies seek to put upon us. Legislation pending before this Committee, Senate Bill 421, would help alleviate this situation.

When you add up the costs of doing business, including rent, utilities, insurance, uniforms, and other incidental costs, it costs the average service station dealer as much as 11 cents to pump a gallon of gasoline today. The dealer's margin is often insufficient to cover the cost of doing business.

In Columbus, my home town, the average dealer margin on our highest volume product is 3.2 cents a gasoline. Again, remember that we must cover our costs of doing business out of this margin. In today's gasoline market, dealers survive by selling high volumes of gasoline at low margins and by relying on ancillary business, such as convenience stores, auto repairs, or both.

It is important for this Committee and the American public to know that gasoline dealers are not reaping additional profits from this episode. In my own case, I have simply passed on the 21-cent increase that I mentioned earlier that was foisted upon me.

Many other dealers have absorbed part of the increase. In some cases, we have been able to hold the line for a while by drawing upon previous inventory. I have done this myself, for as much as three days at one time.

Additionally, no dealer wants to be the first on the street to go up in price. Investigation by various state agencies bear this out.

My customers have dealt with me for a long time because they know they will receive quality service and quality gasoline at a competitive price. I certainly do not want to be part of what is nothing more than a powerful industry seeking to profit from its own misdeed at the expense of my customers and neighbors.

The attention of both the public and this Committee should be on answering the age-old question: How much does an oil company make on a gallon of gasoline? We have some estimates, but we are not prepared to say for sure here today.

Whatever it is, this margin is not good enough for the oil companies. They have decided they also want to be our retail competitors and get that extra 3.2 cents a gallon that we make as well as what they make at wholesale.

The major oil companies have already achieved dominance over the wholesale price of gasoline because of the shutdown of many independent sources of supply, including over 100 domestic refineries. We should not allow them to gain similar control over the retail market.

The impact of the oil company control over the wholesale price is most clearly understood when you compare what happened in 1986, when crude oil prices fell, with what happened in the last few weeks. In 1986, oil companies refused to pass on price cuts made possible by the crude oil price collapse to their independent dealers, but did pass on price cuts to other customers.

Again, the consumer paid. A study by the Citizens/Labor Energy Coalition found that American motorists were cheated out of one billion dollars in the first three months of 1986 by big oil.

I have been told to cut it, Mr. Chairman, so I will.

[The prepared statement of Mr. Stanton follows:]

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Executive Director

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SERVICE STATION DEALERS OF ARKANSAS
CALIFORNIA SERVICE STATION & GARAGE OWNERS ASSN.
NORTHERN CALIFORNIA PETROLEUM RETAILERS ASSN.
SOUTHERN CALIFORNIA SERVICE STATION ASSN.
COLORADO SERVICE STATION DEALERS ASSN.
CONNECTICUT GASOLINE RETAILERS ASSN.
SERVICE STATION DEALERS OF FLORIDA
HAWAII AUTOMOTIVE & RETAIL GASOLINE DEALERS
IDAHO SERVICE STATION ASSN.
ILLINOIS GASOLINE DEALERS ASSN.
INDIANA AUTOMOTIVE SERVICE ASSN.
MIDWEST SERVICE STATION ASSN.
KENTUCKY GASOLINE DEALERS ASSN.
BAYOU STATE GASOLINE RETAILERS ASSN.
GREATER WASHINGTON/MARYLAND SERVICE STATION & AUTO REPAIR ASSN.
BAY STATE GASOLINE RETAILERS ASSN.
MINNESOTA SERVICE STATION ASSN.
PRO AUTOMOTIVE ASSN. OF MISSOURI & KANSAS
AUTOMOTIVE TRADES OF MONTANA
NEVADA GASOLINE RETAILERS
TRI-STATE GASOLINE & AUTOMOTIVE DEALERS ASSN. OF MAINE, NEW HAMPSHIRE & VERMONT
SERVICE STATION DEALERS ASSN. OF NEW MEXICO
NEW YORK STATE ASSN. OF SERVICE STATIONS
NORTH CAROLINA SERVICE STATION ASSN.
NORTH DAKOTA RETAIL GASOLINE DEALERS ASSN.
OHIO COMPETENCE OF SERVICE STATION DEALERS ASSNS.
OREGON GASOLINE DEALERS ASSN.
ASSOCIATED RETAIL GASOLINE DEALERS
PENNSYLVANIA/DELAWARE SERVICE STATION DEALERS ASSN.
SOUTH CAROLINA SERVICE STATION DEALERS ASSN.
TENNESSEE RETAIL GASOLINE DEALERS ASSN.
TEXAS SERVICE STATION ASSN.
LONE STAR SERVICE STATIONS ASSN.
PETROLEUM RETAILERS ORGANIZATION OF UTAH
VIRGINIA GASOLINE & AUTOMOTIVE REPAIR ASSN.
VIRGINIA SERVICE STATION & AUTOMOTIVE SERVICES ASSN.
AUTOMOTIVE UNITED TRADES ORGANIZATION
WEST VIRGINIA GASOLINE DEALERS & AUTOMOTIVE REPAIR ASSN.
WISCONSIN RETAIL GASOLINE & AUTOMOTIVE TRADES ASSN.

OFFICERS
EMMETT PROBUS, President, Louisville, KY
DENNIS HEIL, First Vice President, Wausau, WI
DENNIS DeCOTA, Second Vice President, San Anselmo, CA
DON JOHNSTONE, Third Vice President, Indianapolis, IN
MARY ANN RAGONA, Treasurer, Patchogue, NY

STATEMENT OF

TRACY L. STANTON, Shell Dealer

Bexley, Ohio

Past President of SSDA

BEFORE THE

SENATE SUBCOMMITTEE ON

ENERGY CONSERVATION AND REGULATION

APRIL 17, 1989 HEARING ON

POST-VALDEZ GASOLINE PRICE HIKES

Mr.Chairman,Members of the Committee:

My name is Tracy Stanton,an independent gasoline dealer from Ohio.Iam the past president of the Service Station Dealers of America,the trade association that together with its 43 state and regional affiliates serves as the voice of America's 60,000 independent gasoline retailers.

I have operated Tracy's Shell in Bexley ,Ohio, a suburb of Columbus,for the past 13 years and I have been a dealer for over 21 years.

Since the Valdez catastrophe, my dealer tank wagon , which is the wholesale price I pay the oil company for my gasoline has gone up 19 cents per gallon. My price has gone up further and faster than at any time in my history. This includes both the 1973 Arab oil embargo and the 1979 shortage

This unjustified 19 cents per gallon hike costs me an additional $1848 per 8800 gallon load.It means that my customers are paying to Shell $23,750 a month more.Nationally,this adds up to $11,642,000 per month consumers are paying at the 4500 direct supply Shell

stations. I don't intend to single out Shell as other brands have experienced greater increases,including Exxon,and Shell is ,from a dealer perspective ,the best of the oil companies to deal with.

As the man who must face hundreds of loyal but angry customers each week, I have sought an straight answer as to why prices have shot up faster than during the shortages. I've heard more explainations than Baskin-Robbins has flavors. Every thing from OPEC to environmental regulations has been blamed. The SSDA believes the answer is twofold: oil company greed and the unprecedented control the major oil companies have gained at both upstream at the refinery levl ,and downstream as anti -independent dealer companies such as Mobil increase their numbers of company operated retail outlets.

Unfortunately,the public has vented its frustration at dealers such as myself.Many Exxon stations have been shot at, vandalized,picketed and subjected to bomb threats.The Committee and the American public must realize that the dealers are innocent victims just as the oil covered otters

we see on TV.

We have no control over the wholesale price of gasoline. In some cases, dealers have been able to buy the same brand of gasoline from a middleman distributor 15 cents per gallon cheaper than they can purchase directly from the oil company at "wholesale tankwagon" price. Yet,when we try to get those lower prices for our customers,we are threatened with termination of our franchise. For this reason 19 Exxon dealers filed suit against Exxon in Houston last week, to stop the overcharging of the Texas public.

Not only does the dealer have no control over our wholesale cost,most of our costs of doing business are set by the oil companies.For example,many dealers are forced to stay open during hours which are unsafe and unprofitable.Rents at leased stations are also under the total control of Big Oil. These schemes include variable rents that are based on meeting a pre-determined minimum gallonage.Many companies charge the dealer 3% or more for credit cards ,while pawning these charges off as "discount for cash".

Congress is to blame for this situation becuse the 1978

Petroleum Marketing Practices Act forces dealers to accept any contract provision the oil companies seek to ram down our throats. Legislation pending before this Committee, Senate Bill 421 would help alleviate this situation. Congress must act as the PMPA prempts state law governing grounds for franchise termination.

When you add up the costs of doing business ,including rent, utilities, insurance and other costs; it costs the average dealer up to 11 cents to pump a gallon of gas.

Dealers mark up or margin is often insufficient to cover the costs of doing business. In Columbus ,the average dealer margin on our highest volume product is 3.2 cents per gallon.

The highest margins are found on premium gasoline ,which run to about 10 cents per gallon. Again remember that we must cover our cost of doing business out of this margin. In today's gasoline marketplace dealers survive by selling high volumes of gasoline at low margins and by relying on an ancillary business such as a convenience store, auto repairs or both.

It is very important for this Committee and the American

public to know that gasoline dealers are NOT reaping additional profits from this episode. In my own case I have simply passed on the increase foisted upon me. Many other dealers have absorbed part of the increase. In some cases we have been able to hold the line for a while by drawing upon previous inventory.Additionally, no dealer wants to be the first on the street to go up in price.I have to compete with the Sunoco and Gulf dealers up the street from me.

My customers have dealt with me for a long time because they know they will receive quality service and quality gasoline at a competitive price. I certainly don't want to be part of what is nothing more than a powerful industry seeking to profit from its own misdeed at the expense of my friends and neighbors.

The attention of both the public and this committee should be on answering the age old question:How much does an oil company make on a gallon of gas?

It is amazing to find how many memory lapses you get when you ask that question . Our best estimate is that the oil companies ae making from 13 to 27 cents per gallon of

gasoline. This margin isn't good enough for the oil companies; they've decided they also want to be our retail competitors and get the extra 3.2 cents per gallon as well. For example ,100 of the 300 Mobil stations in Florida,including all new stations are company operated by Mobil,and they've just picked up more in an exchange with BP America.

In the case of BP, the market leader in Ohio,we have found at least one instance in which the company is charging its own retail outlet 20 cents per gallon less than a direct supplied independent dealer within 2 miles of the company operated facility. Congress should not allow oil companies to run independent dealers and jobber-wholesalers out of business by refusing to make product available at a competetive price.We believe an appropiate legislative solution is in order.

The major oil companies have already achieved dominance over the wholesale price of gasoline because of the shut down of many independent sources of supply including over 100 domestic refineries. We should not allow them to gain

similiar control over the retail market.

The impact of the oil company control over the wholesale price is most clearly understood when you compare what happened in 1986, when crude oil prices fell ,with what has happened in last few weeks.

In 1986, oil companies refused to pass on price cuts made possible by the crude oil price collapse to their independent dealers, but did pass on the price cuts to other customers . A study by The Citizens/Labor Energy Coalition found that American motorists were cheated out of $1 billion dollars in the first 3 months of 1986 by Big Oil because dealers such as myself were being ripped off at the wholesale level. The study included the cities of Washington,D.C.,Indianapolis, New York, Denver,Chicago, Boston, Los Angeles, Newark,Philadelphia, Detroit,Atlanta, Tulsa, and Miami. It found that where oil companies had the largest market share, the prices stayed higher.

When asked by Congress about this rip-off of dealers and consumers,Big Oil again came up with a number of excuses. Testimony by the oil companies stated that it takes 45 to 60

days from the time oil is pumped out of the ground to the time it is refined into gasoline and delivered to a service station for sale to the public. So when crude prices fall it takes 60 days for dealers and consumers to benefit from the lower prices ,but within a matter of hours and days after Valdez we get socked with massive price hikes!

Neither I as a dealer,nor my customers buy the idea that this is all some kind of fluke. The only people who benefitted in 1986 and again now are the oil companies.

Exxon alone made $1.2 billion in profit from refining and marketing alone last year. Why did they need to take more out of our pockets?

My customers have asked me if prices will come back down or at least stabilize. I think they will stabilize a little, or not go up as fast so long as there is a threat of legal or legislative response to this round of dealer and consumer gouging.

I base this conclusion in part on an internal oil company document known as the Arco SPU document discovered by the Nevada legislature in 1987.That document detailed how

Arco would drive its dealers out of business through massive rent hikes,then company operate the stations. They knew a political response would occur to the elimination of the "dealer apparatus" as these innocent people were called. Arco planned to keep prices low until the political resistence faded,at which time it would then move to reestablish market control and a period of "quite acceptable, lasting profitability. Nevada enacted legislation to prohibit Arco and other oil companies from expanding their number of company -operated retail facilites.

I am making two points here: First ,that oil company greed can be kept in check by threat of a legislative response ,that is why this hearing is so important;and second that Congress should immediately consider legislation such as Nevada's to prohibit the oil companies from taking over the retail market .

CONCLUSION

Gasoline dealers have been hit with wholesale price increases that exceed those experienced during the shortages of the 70's. Gas has never gone up so far ,so fast.

Dealers have endorsed Transportation Secretary Skinner's call for a rollback of wholesale prices.

Dealers are very upset by the fact that when crude prices fell in 1986, it took months for the wholesale dealer tankwagon price to fall; yet within a matter of hours after Valdez oil companies were already jacking up prices and ripping off dealers and consumers.

The oil companies have plenty of room in their profit margins to provide station operators with a lower wholesale price so that retail prices to consumers can be lowered.

Congress needs to take a legislative response to insure such an episode does not happen again.

Senate Bill 421,amending the Petroleum Marketing Practices Act, is currently pending before this Subcommittee and could serve as the vehicle to insure that the necessary protections for retail dealers,wholesalers, and consumers are enacted.

ATTACHMENT 3

THE GREAT GASOLINE STICK-UP

How the Major Oil Companies Cheated American Motorists Out of $1 Billion in the First Three Months of 1986

A Research Report

by the

Citizen/Labor Energy Coalition

April, 1986

FINDINGS

According to oil industry and government data analyzed by C/LEC:

- During the first three months of 1986, as oil prices were tumbling worldwide, the major U.S. oil companies used their market power to deprive American motorists of $1 billion in lower gasoline prices.

- The eight largest U.S. oil companies control over 56 percent of the nation's refinery capacity and over 52 percent of gasoline sales nationwide. These percentages are much higher in specific markets, cities, states and regions.

- Nationally, Chevron, Exxon, Shell, Amoco, Texaco, Mobil, Arco and U.S. Steel's Marathon Oil had 56.1 percent of refining capacity in 1984. Similarly, Chevron, Amoco, Texaco, Shell, Exxon, Mobil, Arco and Unocal sold 52.1 percent of the nation's gasoline in 1984.

- The concentration of control over wholesale gasoline sales by the eight largest companies in many states is substantial. In the District of Columbia the 8-largest companies supply 100% of the market. In Pennsylvania 84 percent. In Maryland 84 percent. In California, 82 percent.

- In 1984 in Washington, D.C. four companies -- Amoco, Exxon, Shell and Texaco had 58% of the retail gasoline market. Arco, Exxon, Gulf and Mobil had 59 percent of the retail gasoline market in Philadelphia. Gulf, Exxon, Shell and Texaco had 84% of the gasoline market in Houston.

- In states and cities where the eight largest companies have the lion's share of the gasoline market, retail prices lagged far behind wholesale prices. In contrast, in cities and states where the 8-largest companies have a small share of the market, retail prices closely tracked wholesale prices.

- The major oil companies boosted retail prices by charging their own gasoline dealers prices as much as 30 cents per gallon more than they were charging other customers at their refineries. The normal difference in price is 5 cents to 7 cents per gallon. In response dealers in many states are suing their major oil company suppliers for price discrimination.

- In the cities of Washington, D.C., New York, Chicago, Boston, Philadelphia, Los Angeles and Miami, wholesale prices fell 35 to 40 cents per gallon between December and the end of March, while retail prices only dropped 10 to 25 cents per gallon.

- During February and March the nation's refiners sharply cut back refinery operations from over 80 percent capacity utilization in January to 77 percent during February and to 75 percent during March. As a result refiners have reduced gasoline production by 500,000 barrels per day during March and have reduced gasoline inventories by over 19 million barrels since the end of February. In response, wholesale gasoline prices are rising, despite lower crude oil costs.

- By reducing gasoline production and inventories, U.S. refiners are acting together to help prop up gasoline prices and thereby support crude oil prices. If gasoline stocks continue to decline or stabilize at too low a level for the demands of the upcoming driving season, consumers, particularly those on the East Coast and other markets dominated by the major oil companies, can expect higher prices--5 cents or more per gallon-- at the gasoline pumps this summer.

Table XV

CALCULATION OF MAJOR OIL COMPANY GASOLINE OVERPRICING
January - March 1986

Estimated national gasoline consumption
January - March: 24.9 bill. gals.

Eight-firm Mkt. Share 52%

Estimated Sales for Top 8 Firms
January - March: 12.9 bill. gals.

Estimated Average Overprice Per Gallon
January - March: 11 cts/gal.

Assume Overpricing Occurs in 75% of Top 8 Sales:
12.9 X .11 X .75 = $1.067 billion

as dealers file antitrust suit against majors

Dealer-jobber price gap still yawns wide

Majors are slashing DTW numbers in big chunks as they feel the heat from dealers over the still-huge gap between jobber rack and DTW prices, but they're not cutting fast or deep enough say retailers.

Though some majors cut DTWs as much as 8cts last week, a random survey shows the average rack-DTW gap still running 13.62cts to 26.45cts (see chart below). In our survey of the same majors' prices two weeks ago, the spread was 13.76cts to 25.48cts (OE 3/3).

Chevron-Gulf registered the largest DTW drop, the average differential falling from 17.23cts two weeks ago to 15.62cts this week. It now has some of the lowest DTWs in the East, with many cities below 60cts gal. (For moves by individual refiners, see charts at side of page).

Generally, the East Coast had the widest gaps, with spreads of over 30cts, notably BP in Baltimore and Boston, Sun and Mobil in Newark. Spreads narrow to 10cts in the Rockies, 15cts on the West Coast. According to Oil Price Information Service, average spreads look like this:

Company	Rack-DTW gap	Spread on 3/3
Amoco	13.62cts	13.76cts
Chevron	15.62cts	17.23cts
Getty	25.98cts	24.76cts
Sohio/Gulf/BP	26.45cts	25.48cts
Marathon	15.06cts	15.56cts
Mobil	23.45cts	22.97cts
Sunoco	26.15cts	24.35cts

Meantime, dealers continue to fight for lower DTWs:

● In Texas, 16 dealers were to file an anti-trust suit in U.S. District Court at presstime against Mobil, Exxon, Texaco, Chevron-Gulf and Shell claiming price-fixing and violations of the RICO Act. The dealers raised $25,000 in two days to finance the suit, being filed on behalf of all Texas retailers. As disclosed 3/10, Texaco dealer L.J. Doucet reached an out-of-court settlement over his case against Texaco after Texaco agreed to let him buy at jobber rack price for 45 days. Other state dealers were not happy with the settlement, hence this new suit.

● In Alabama, Chevron dealers were to meet with lawyers late last week to discuss a suit against all majors operating in the state. Meantime, after Chevron retailers rebelled last week, top pricing managers in the state flew to California to huddle with Chevron brass. One dealer says he's heard hints of an entirely new pricing system that might be offered to dealers. Though Chevron narrowed its rack-DTW spread from 22cts to 13.6cts in the state last week, dealers still claim losses.

● In Georgia, dealers who sued six majors for breach of a state below-cost sales law were regrouping late last week after a county judge found the law unconstitutional. Options under consideration: Appeal of the county judge's ruling, a new suit in another county, and/or a U.S. court action. Some dealers have lost 50% of their volume to jobbers, with one jobber showing street prices 2cts-6cts below a lessee dealer station just 700 feet away.

Following prices, from Oil Price Information Service, show jobber rack-DTW spreads last week at randomly selected terminals. Prices are for unleaded gasoline and don't include rebates or incentives which would cut spreads a cent or so.

Amoco	Rack	DTW
Atlanta	48.5	61.0
Baltimore	67.6	82.0
Miami	60.5	69.2
Chicago	46.0	60.5
Detroit	41.6	59.6

Chevron	Rack	DTW
Atlanta	40.7	54.2
Boston	45.45	63.9
Miami	43.8	65.1
Denver	42.0	50.2
L.Angeles	50.0	64.5
Newark	41.1	58.4

Sohio/Gulf	Rack	DTW
Atlanta	43.2	60.5
Miami	48.0	72.5
Baltimore	45.05	82.0
Boston	44.2	76.5
Columbus Oh.	41.0	64.4

Mobil	Rack	DTW
Atlanta	41.7	61.6
Boston	47.0	71.0
Newark	41.7	72.3
Philadelphia	43.1	67.0
Chicago	40.3	62.6
Detroit	39.45	59.1

Sunoco	Rack	DTW
Baltimore	47.4	76.7
Boston	50.45	74.0
Newark	47.20	77.3
Philadelphia	45.70	71.1
Chicago	42.20	66.0
Detroit	41.25	66.0

Marathon	Rack	DTW
Chicago	40.0	53.6
Columbus, Oh.	41.3	56.5
Detroit	39.3	54.4
Indpolis	39.95	46.3

Getty	Rack	DTW
Boston	46.3	69.0
New Haven	46.2	72.82
Newark	42.75	74.13
Philadelphia	43.0	65.60

Weekly Vital Statistics and Analysis in Oil Marketing

Published Fridays

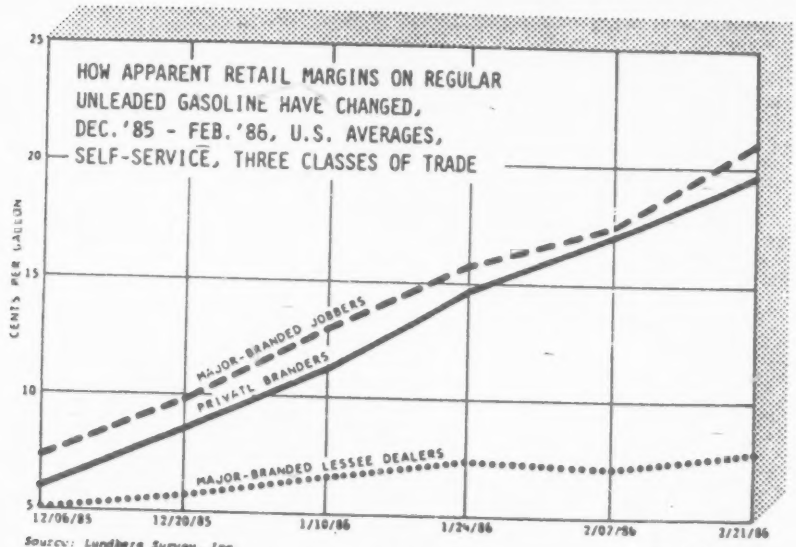
RECEIVED MAR 1 2 1986

VOLUME XIII NUMBER 19

MARCH 7, 1986

Saved By The Bell

Retail Gasoline Margins Stratified



Source: Lundberg Survey, Inc. *Lundberg Letter Chart*

Note: For these calculations, wholesale prices to jobbers and private branders are freight-adjusted; margins for these two classes of trade are terminal-to-retail.

FALLING RETAIL GASOLINE prices are making most people happy these days, as lower crude oil acquisition costs continue to work their way through the refining and distribution systems. Unhappy marketers are those with smaller cuts to pass through than does local competition. A close look at how margins are faring by class of trade yields some hints about what to expect of gasoline price competition during the 1986 summer driving season.

Trudy Lundberg Editor Dan Lundberg APR, Publisher

Contributing Editors John Ayling, Mrs Enquist, Jon C Lundberg Graphics Chu Shan Business Manager Hoda B Shalton Production Craig P Hayden

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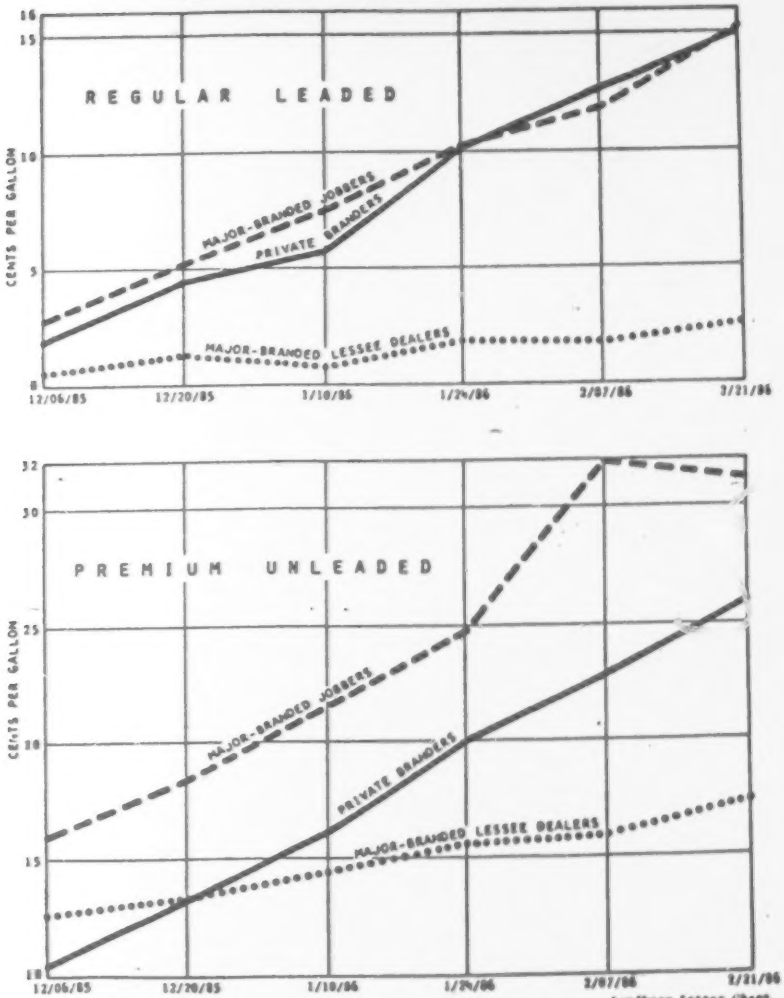
Mailing address: P O Box 3000, Newport Beach, California 92659-0883, U S A Telephone (714) 708-8141 TWX 910 596-1958

U.S. AVERAGE APPARENT RETAIL MARGINS, DEC.'85 - FEB.'86
SELF-SERVICE, THREE CLASSES OF TRADE



Source: Lundberg Survey, Inc.
Note: For these calculations, wholesale prices to jobbers and private brandors are freight-adjusted; margins for these two classes of trade are terminal-to-retail.

Senator METZENBAUM. Well, your entire statement will be included in the record, and I certainly think you have made your point and we are very pleased that you saw fit to join us, and I particularly appreciate it since you come from Ohio.

Mr. STANTON. Thank you.

Senator METZENBAUM. Mr. Potter, President of Potter Tire and Oil Company, Morehead City, North Carolina, Past President of the Petroleum Marketers Association of America. Happy to have you with us, sir, and I think you are the Exxon distributor, is that correct?

STATEMENT OF TOM POTTER, SR., PRESIDENT, TOM POTTER OIL CO., AND PAST PRESIDENT, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, ACCOMPANIED BY PHILLIP R. CHISHOLM, EXECUTIVE VICE PRESIDENT, PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. POTTER. That is correct.

The CHAIRMAN. Okay, I was confused. Please proceed.

Mr. POTTER. But I have never been known not to hold back my feelings, whether I was in their presence or not, Senator.

Thank you, Mr. Chairman. My name is Tom Potter, Senior, and I am President of Tom Potter Oil Company, a gasoline and heating oil distribution company in Morehead City, North Carolina.

I am appearing today on behalf of the Petroleum Marketers Association of America. I am accompanied this morning by Phillip R. Chisholm, the Executive Vice President of PMAA.

The price of motor gasoline posted prominently on street corners throughout the country has been called the most visible consumer price in America. This sensitivity to prices has recently been underscored by consumer and media reaction to the gasoline price increases that followed the *Exxon Valdez* oil spill.

Considerable attention has been focused on the extent to which product prices should respond to a supply disruption of this kind. While gasoline prices have undoubtedly responded to the immediate loss of crude supplies resulting from temporary closure of the Valdez terminal, it is incorrect to attribute all of the recent price increases to the *Exxon Valdez* incident.

Prices had been on an upward spiral for several weeks prior to the spill. My personal experience may prove to be a useful example. I purchase gasoline from as many as five different suppliers. My prime supplier is Exxon. I am an Exxon franchisee and own and operate Exxon stations. My other four suppliers are independent refiners, from whom I purchase product for my unbranded outlets.

In the five week period prior to the spill, my wholesale price from Exxon for regular unleaded gasoline increased 13.3 percent, that is from 51.6 to 58.5 cents per gallon. The average increase for my other four suppliers was 14.4 percent, from 50.6 to 57.9 cents per gallon.

During the three-week period after the spill, my wholesale prices from Exxon increased 21 percent, from 58.5 to 70.8 cents per gallon. The unbranded independent prices increased 21.5 percent, that is from 57.9 to 70.3 cents per gallon.

I understand that my experience was not unusual. Marketers in other parts of the country have experienced a similar situation.

As independent marketers, we are very concerned about these price trends. There seems to be a general assumption that if wholesale prices rise, then those increases are automatically passed through at the retail level. That is absolutely not the case.

Again, I believe my experience is illustrative of the rest of the country. While my Exxon wholesale price went up over 34 percent from the middle of February through April the 13th, my retail price increased only 17.8 percent. Because of competitive pressures in my market, I was forced to absorb nearly three cents per gallon of the wholesale price increase.

Similarly, with my unbranded stations, while my wholesale price was rising by over 36 percent, my retail price increased only 18 percent, and in this instance I was forced to absorb four cents of that increase.

As a wholesale, I am generally not hesitant to be critical of price increases, particularly when competitive pressures limit my ability to pass those increases through. However, the reality is that consumers are feeling a far smaller price impact than are many wholesalers.

What must be understood is that many factors affect gasoline prices. While responsive to the price of crude oil, gasoline prices are increasingly driven by the circumstances that are peculiar to gasoline markets. Over the past several years, motor gasoline supplies have tightened during the summer's peak demand months, as demand levels have steadily increased and the nation's refinery capacity has decreased.

There are numerous other factors that affect gasoline markets. The Reid vapor pressure and underground storage tanks mandated by EPA will cause these prices to go.

In conclusion, the *Exxon Valdez* instance was a tremendous national tragedy and it certainly did have an effect on the price spikes which have occurred since that time. It would be almost too easy for PMAA and others to point to that incident and use it as the sole reason prices have increased over the past few weeks.

It would be easy, but it would be wrong and it would be dangerous. There needs to be a better understanding as to all the elements which affect retail gasoline prices. I hope my testimony has contributed to that understanding.

If you have any answers, I will try to answer them.

[The prepared statement of Mr. Potter follows:]

PMAA PETROLEUM MARKETERS ASSOCIATION OF AMERICA

TESTIMONY

Before the

Subcommittee on Energy Regulation and Conservation
Committee on Energy and Natural Resources
United States Senate
Washington, D.C.

on

Recent Increases in the Prices of Petroleum Products

by

Tom Potter, Sr., President, Tom Potter Oil Company
Morehead City, North Carolina

on behalf of the

PETROLEUM MARKETERS ASSOCIATION OF AMERICA

April 17, 1989

1120 VERMONT AVENUE, NW • SUITE 1130 • WASHINGTON, DC 20005 • (202) 331-1190

MEMBERS OF THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA

The Petroleum Marketers Association of America (PMAA) represents the independent petroleum marketers who are members of these state and regional trade associations:

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Arizona Petroleum Marketers Association
Arkansas Oil Marketers Association, Inc.
California Independent Oil Marketers Association
Colorado Petroleum Marketers Association
Independent Connecticut Petroleum Association
Florida Petroleum Marketers Association
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Idaho Oil Marketers Association
Illinois Petroleum Marketers Association
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Kentucky Petroleum Marketers Association
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Maine Oil Dealers Association
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The Petroleum Marketers Association of America is located at 1120 Vermont Avenue, N.W., Suite 1130, Washington, D.C. 20005. Telephone: (202) 331-1198. Fax: (202) 467-6330

Good morning, Mr. Chairman and members of the Subcommittee. My name is Tom Potter, Sr. and I am President of Tom Potter Oil Company, a gasoline and heating oil distribution company in Morehead City, North Carolina. I am appearing today on behalf of the Petroleum Marketers Association of America (PMAA). I was honored to serve as President of PMAA in 1986.

PMAA, through its 43 state and regional associations, represents nearly 11,000 small, independent petroleum product wholesalers and retailers. Virtually all of these marketers are considered small businesses according to guidelines established by the Small Business Administration. Collectively, these marketers sell over half the gasoline, three-quarters of the home heating oil and nearly 60 percent of the diesel fuel consumed in the United States annually. I am accompanied this morning by Phillip R. Chisholm, the Executive Vice President of the Petroleum Marketers Association of America.

The price of motor gasoline, posted prominently on street corners throughout the country has been called the most visible consumer price in America. This sensitivity to prices has recently been underscored by consumer and media reaction to the gasoline price increases that followed the Exxon Valdez oil spill; considerable attention has been focused on the extent to which product prices **should** respond to a supply disruption of this kind. Distrust of market players and some measure of misinformation have both been in evidence. What seems to be lacking is a clear understanding of market relationships, and how these have changed over time.

While gasoline prices have undoubtedly responded to the immediate loss of crude supplies resulting from temporary closure of the Valdez terminal, it is incorrect to attribute all of the recent price increases to the Exxon Valdez incident. Gasoline prices have clearly risen, in some cases precipitously, since the oil spill. However, prices had been on an upward spiral for several weeks prior to the spill.

PERSONAL IMPACT

My personal experience may prove to be a useful example. I purchase gasoline from as many as five different suppliers. My prime supplier is Exxon. I am an Exxon franchisee and own and operate Exxon stations. My other four suppliers are independent refiners from whom I purchase product for my unbranded outlets.

In the five week period prior to the spill (February 16 - March 23), my wholesale price from Exxon for regular unleaded gasoline increased 13.3 percent, from 51.6 to 58.51 cents per gallon. The average increase from my other four suppliers was 14.4 percent, from 50.63 to 57.93 cents per gallon.

During the three week period after the spill (March 24 to April 13) my wholesale prices from Exxon increased 21 percent, from 58.51 to 70.81 cents per gallon. The unbranded independent prices increased 21.5 percent, from 57.93 to 70.36 cents per gallon.

I understand that my experience was not unusual. In PAD V (the West Coast) wholesale prices for unleaded gasoline have increased each week since the beginning of the year, rising over 10 cents per gallon between the first week of January and the middle of March. From March 24th through April 7th the wholesale price rose 17.8 cents per gallon. Similar, though smaller increases were recorded in other parts of the country.

As independent marketers, we are very concerned about these price trends. There seems to be a general assumption that if wholesale prices rise then those increases are automatically passed through at the retail level. That is absolutely not the case and again I believe my experience is illustrative of the rest of thE country.

While my Exxon wholesale price went up over 34 percent from the middle of February through April 13, my retail price increased only 17.8 percent. Because of competitive pressures in my market, I was forced to absorb nearly 3 cents per gallon of the wholesale price increase. Similarly, with my unbranded stations, while my wholesale price was rising by over 36 percent, my retail price increased only 18 percent. In this instance I was forced to absorb nearly 4 cents of the increase.

NATIONAL PRICE SHIFTS

While I am unable to present national figures that are as up to date as my own, this trend of wholesale prices accelerating more rapidly than retail would appear to be true nationwide, at least through the end of March. On the West Coast, for example, the average retail price of gasoline increased less than 3 cents per gallon from the week before the spill to the week after at the same time that wholesale prices increased nearly 10 cents per gallon.

Again, other areas of the country experienced similar increases. From March 3 to March 31, in PAD I (the East Coast), wholesale prices increased 13.9 percent while retail prices rose 2.7 percent. During the same period in PAD II (Midwest), the increases were 15.5 percent wholesale and 9.3 percent retail. In PAD III (Gulf Coast) the price rises were 13.1 percent wholesale and 4.8 percent retail. I understand that it may be little solace, but the reality is that consumers are feeling a far smaller price impact than are many wholesalers.

As a wholesaler, I am generally not hesitant to be critical of price increases, particularly when competitive pressures limit my ability to passthrough those increases. However, given the recent events surrounding these increases, including the Alaskan oil spill, and the history of price increases and decreases over the last several years, I do not believe any conclusion can be drawn at this point other than that the gasoline marketplace is exhibiting the normal characteristics of a free market premised on factors associated with supply and demand.

Exhibits I through IV provide a summary of weekly price trends for the period October, 1988 through March, 1989 for different regions of the country.

While these graphs depict the general upward drift in prices described above, they also illustrate the relative relationships among the various prices over time. Of particular interest is the fact that retail prices seem to be relatively flat, exhibiting smaller changes than are evident in either crude oil or wholesale gasoline prices.

** (Prices shown are: 1) spot crude oil, West Texas Intermediate, 2) wholesale unleaded regular gasoline (based on average branded rack postings); and 3) retail unleaded gasoline, self-serve, ex tax.)

It is also instructive to note the relative flatness of retail prices at a time of steadily rising crude oil prices. In fact, it is increasingly evident that motor gasoline prices are no longer as closely linked to crude oil prices as they once were. Exhibit V shows crude oil and motor gasoline prices over the past three years. While these price series generally move together, there are also periods of distinct divergence evident, particularly during the summers of 1986 and 1988. These periods were characterized by falling crude oil prices and increases in gasoline prices.

MANY FACTORS AFFECT PRICE

Simply stated, motor gasoline prices, while responsive to the price of crude oil, are increasingly driven by the circumstances that are particular to gasoline markets. Over the past several years, motor gasoline supplies have tightened during the summer's peak demand months as demand levels have steadily increased, and the nation's refinery capacity has decreased. This has rendered gasoline supplies (and thus prices) particularly sensitive to transitory supply shocks, even relatively small ones. For example, a fire at a large Shell refinery during the summer of 1988, although local in nature, had a noticeable impact on national gasoline markets.

There are numerous other factors affecting gasoline markets which would cause them to act somewhat independently of crude oil. First, there are increasing environmental costs associated with gasoline marketing. Two of the most obvious costs relate to the reduction in Reid Vapor Pressure of gasoline mandated by the Environmental Protection Agency and the new underground storage tank and financial responsibility regulations issued by the same agency. This latter requirement will cost service station owners, such as myself, tens of thousands of dollars per outlet to come into compliance. In addition, many states have stricter requirements in both of these areas than does EPA.

Secondly, the nature of the gasoline market is changing dramatically. No longer are gasoline purchases associated strictly with the purchase of other car care items. Today people buy bread, milk, beer, film, toiletries, and many other things at the same location they buy gasoline. This has brought many new, non-integrated entities into the marketplace which view gasoline as just another commodity to be bought and sold with no linkage to the raw material - crude oil.

Another reason motor gasoline prices and crude oil prices may not move in tandem is because crude oil markets are driven at times by remote international events. In general, crude prices tend to be more volatile than product prices, moving up and down with frequency and ease. Exhibit VI summarizes price trends during the past three years in three major time periods during which crude prices rose steadily, then fell, then increased again. Between July 1986 and August 1987, crude oil prices increased nearly 72 percent while the retail price of gasoline rose only 12 percent. The following year, from August 1987 through October 1988, crude prices fell 33 percent, which was accompanied by a 4 percent drop in gasoline prices. Most recently, from October 1988 through March 1989, crude prices again increased, by over 50 percent, while gasoline prices rose only 4 percent.

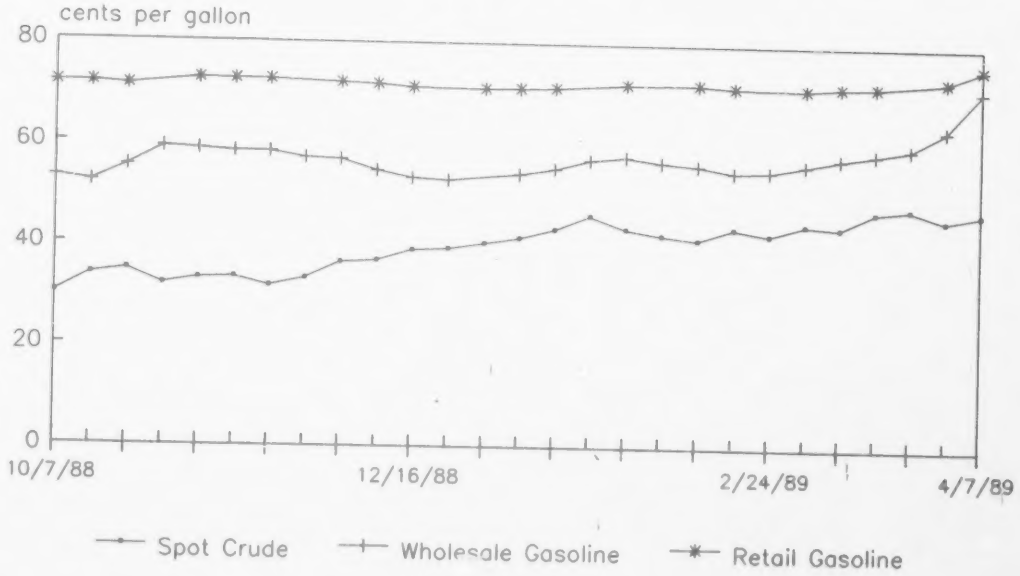
SUMMARY:

The Exxon Valdez incident was a tremendous national tragedy, and it certainly did have an effect on the price spikes which have occurred since that time. It would be almost too easy for PMAA and others to point to that incident and use it as the sole reason prices have risen over the past few weeks. It would be easy, but it would be wrong and it would be dangerous. There needs to ba a better understanding as to all the elements which affect retail gasoline prices. I hope my testimony has contributed to that understanding.

If I can answer any questions, I will be happy to do so.

EXHIBIT 1

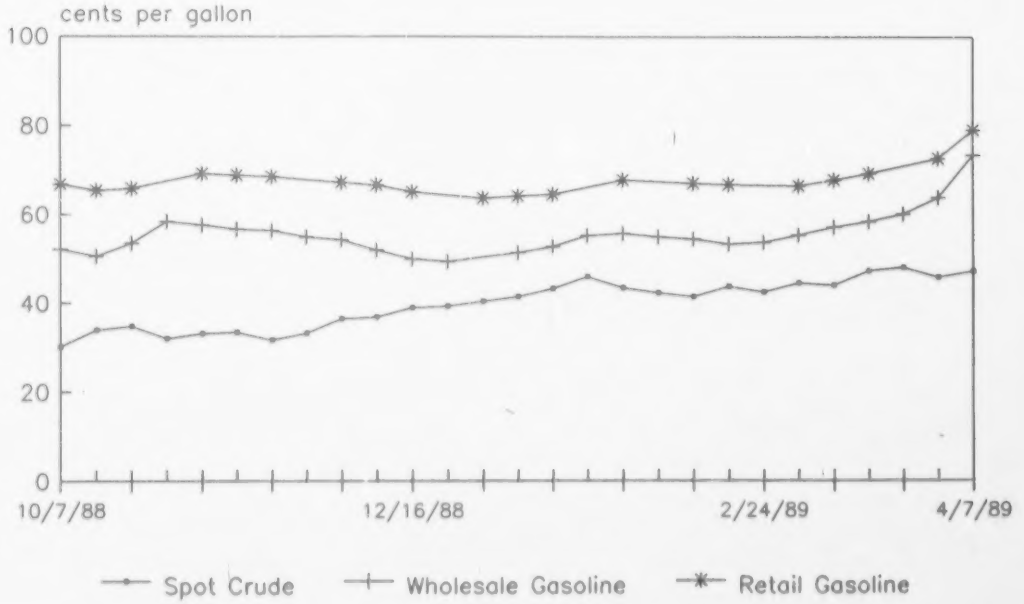
East Coast Petroleum Prices: Crude Oil vs. Wholesale and Retail Unleaded Motor Gasoline



Source: Wall Street Journal, U.S. Oil Week, and Oil and Gas Journal

EXHIBIT II

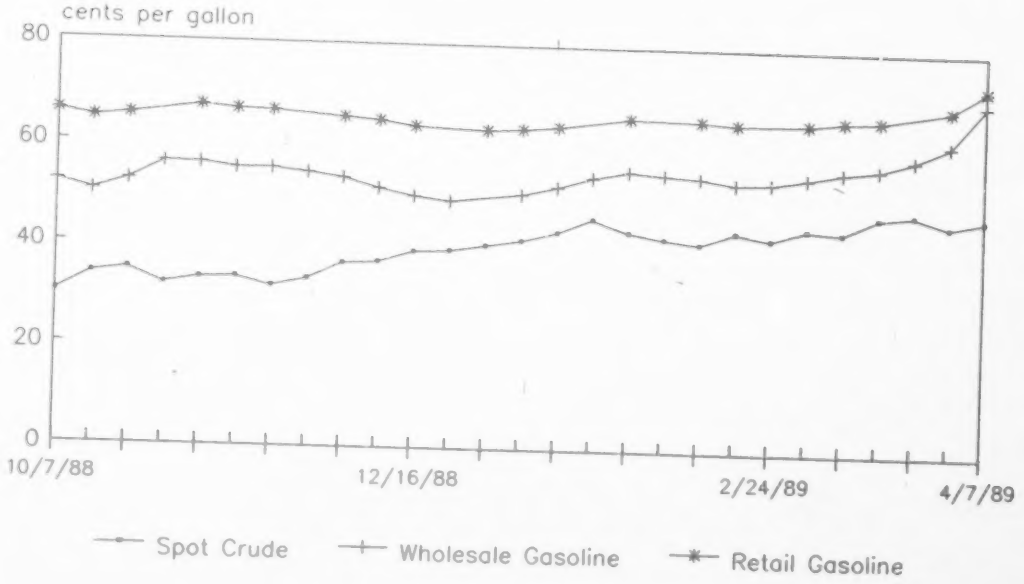
Midwest Petroleum Prices: Crude Oil vs. Wholesale and Retail Unleaded Gasoline



Source: Wall Street Journal, U.S. Oil Week, and Oil and Gas Journal

EXHIBIT III

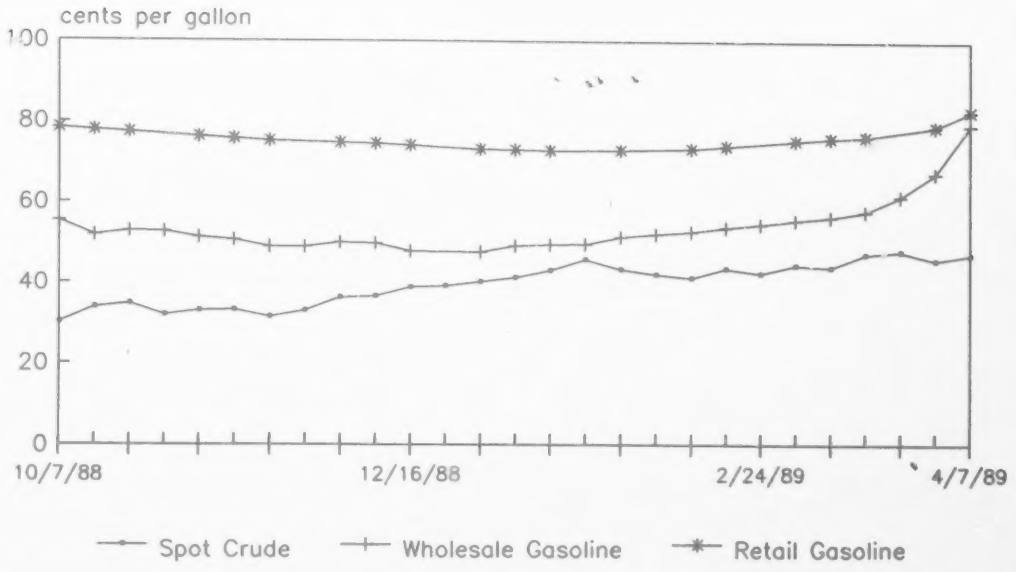
Gulf Coast Petroleum Prices: Crude Oil vs. Wholesale and Retail Unleaded Gasoline



Source: Wall Street Journal, U.S. Oil Week, and Oil and Gas Journal.

EXHIBIT IV

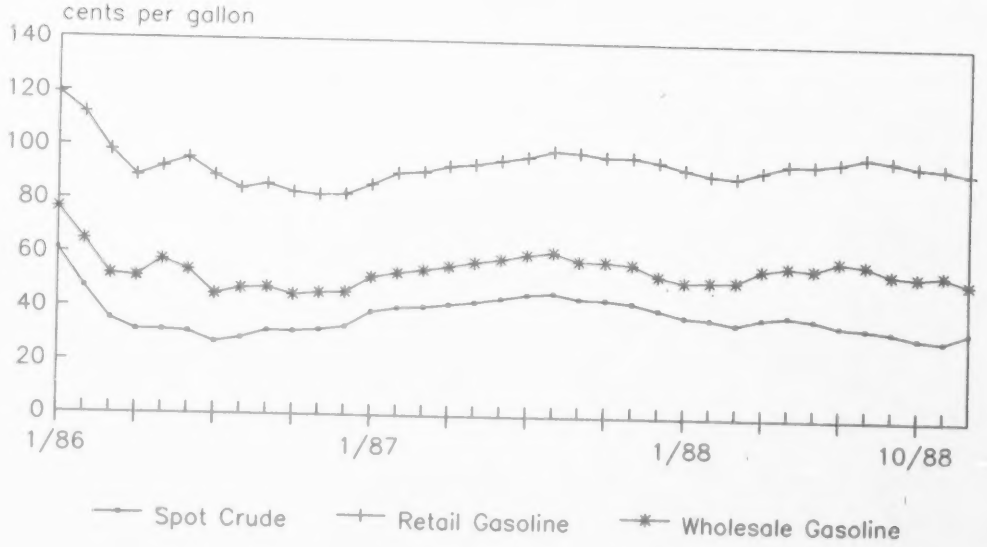
West Coast Petroleum Prices: Crude Oil vs. Wholesale and Retail Unleaded Gasoline



Source: Wall Street Journal, U.S. Oil Week, and Oil and Gas Journal

EXHIBIT V

U.S. Petroleum Price Trends:
Crude Oil and Unleaded Motor
Gasoline, 1986–1988



Source: U.S Department of Energy,
Petroleum Marketing Monthly and Weekly
Petroleum Status Report

EXHIBIT VI

Relative Price Changes,
Crude Oil vs. Retail and Wholesale
Unleaded Motor Gasoline

Time Period	Change in Crude Price	Change in Gasoline Price Wholesale	Change in Gasoline Price Retail
		Percent	
July 1986 - August 1987	+71.9	+37.5	+11.8
August 1987 - October 1988	-33.1	-12.5	- 3.9
October 1988 - March 1989	+52.2	+20.9	+ 4.0

Source: US DOE, US Oil Week, The Wallstreet Journal, Oil and Gas Journal

Senator METZENBAUM. Thank you very much. We appreciate your testimony very much.

I have a few questions. Mr. Lichtblau, when was the last time we saw a gasoline price hike of this rapidity and size?

Mr. LICHTBLAU. Not for quite some time. I do not think we even saw it in 1979, when crude oil prices increased substantially. But this is a very brief period. If gasoline prices approximately stay where they are, then over a five, six, eight week period this will be a much smaller price increase.

It is just when you take the first two weeks, it is like when you take any price increase, the day it occurs it is dramatic. If it stays where it is, after a while it is much less dramatic.

So you cannot just look at this two-week period since March 24th and say this was the most dramatic increase in gasoline prices. The data are not in. Four or five weeks from now we may see a little more whether these prices really exploded or whether it is just an increase that leveled off.

Senator METZENBAUM. Now, I have some data here from the Lundberg letter which says "Perspectives on Port Valdez disaster," and these are the "U.S. weighted average retail gasoline prices, historical points and 1989 to date." They show that back in March of 1981 prices were up to about 137.82. The lowest was in the 80's, 84.63.

Then they come over to December of 1988, 99.61, and that same figure remains constant December 2nd, December 16th, January 6th, 1989, January 20th, 1989, February 3rd, 1989, February 17th, 1989, March 3rd, 1989.

Then we have Valdez between March 17th and April 7th, and on April 7th we see that it jumped from 100.39 to 110.63.

Is that not rather convincing evidence that the Valdez disaster was truly the major reason that the oil companies of this country raised their prices at that point?

Mr. LICHTBLAU. No, sir, I do not think so. I think what you are seeing is, as I said before, a continuation of a trend that started earlier.

Senator METZENBAUM. There is no trend there, Mr. Lichtblau. It is exactly flat. It is flat. That is not a trend. It is a flat line.

Mr. LICHTBLAU. Yes, but crude oil prices is really the principal cost factor, and they increased substantially, as everybody has said here. And sooner or later, you cannot have an 18, 19 cent increase in crude oil prices, when that represents 70 percent of the wholesale price of gasoline, without passing it through.

And as I said, the reason why it was not passed through earlier is because it was not clear that these prices would stay. There was an assumption that crude oil prices would start declining again.

When it was clear that they would not, the industry started to pass it through. If there had been no Valdez incident, the increase in crude oil—in gasoline prices would have been somewhat slower, but the direction would have been the same and ultimately the entire amount of the crude oil price increase would have been passed on.

So Valdez was not totally without any influence on the price of gasoline.

Senator METZENBAUM. Just one simple question, Mr. Lichtblau. The Petroleum Industry Research Foundation, is that foundation funded by the oil industry?

Mr. LICHTBLAU. Yes, oil companies, not by the industry.

Senator METZENBAUM. Five companies?

Mr. LICHTBLAU. No, no.

Senator METZENBAUM. Over five.

Mr. LICHTBLAU. All the companies, from small independent marketers to large international companies.

Senator METZENBAUM. Mr. Rothschild, would you care to comment on the same questions that I have just asked Mr. Lichtblau?

Mr. ROTHSCHILD. Well, Senator, I think it is clear that, yes, crude oil prices were going up, and yes, there were some increases in gasoline prices. But I think the Valdez incident basically provided the companies with a very good opportunity to drastically increase gasoline prices very sharply, to very high levels, and very quickly.

That would not have happened otherwise, had the Valdez incident not occurred. We do not know what would have happened over the future, whether or not the companies would have been able to capture their crude costs through higher gasoline prices.

If you believe the industry that it is very competitive out there, then maybe they could not have. If you believe an analysis that says it is not very competitive out there, yes, eventually I think they would have raised gasoline prices, particularly in the summer, because the oil companies were already preparing the public to say, well, look, we have these Reid vapor pressure standards, it is going to cost us several cents a gallon.

They were setting the stage for higher prices in the summer. But there is no way that I agree that the Valdez incident did not provide the pretext for the companies to drastically increase prices in a very short time.

Senator METZENBAUM. Mr. Rothschild, how do the oil companies maintain high prices? In other words, why does not the competitive pressure of customer shopping keep it that way?

I notice down in Florida, where we have a place that we visit at times, that Hess is always two cents a gallon less than the other oil companies. Now, customers have plenty of information. They know the price of their gas that they buy to the nearest tenth of a cent, and they have plenty of choices.

Why is not the oil industry more competitive than it is?

Mr. ROTHSCHILD. Well, it depends a lot on location. If you come to Washington, D.C., I do not think you will find any, in Washington, D.C., particularly, not in the outlying areas, very many independent stations.

Independents, presumably like Hess and Crown, where I shop out in Virginia, tend to price-cut and compete. The majors tend not to compete. The majors tend to keep their prices fairly close together and watch each other.

On the West Coast, the example is Chevron. Chevron tends to lead prices there. In New York and the East Coast, Mobil tends to lead prices there. There tends to be a price leader.

The independent companies, however, the smaller companies who compete and want to market gas more efficiently and more effectively to consumers, they will tend to cut the price. So again, it

depends on each market, how many independents there are, how many competitors there are. In markets where there are few competitors, the prices tend to be higher.

Senator METZENBAUM. Mr. Potter, Mr. Stanton, perhaps you might want to comment as to whether there are any comparisons between the dramatic price increases and panic in gasoline markets that occurred recently after Valdez with your past experiences during the Iranian revolution in 1979 and the Arab embargo in 1973 and 1974.

Mr. Potter, would you like to take that first?

Mr. POTTER. Mr. Chairman, I do not remember. At my age now, you know, it is hard for me to remember what time I got up this morning.

Senator METZENBAUM. You look pretty young to me, Mr. Potter.

Mr. POTTER. No, sir. I will be proud to say I will be 61 in October.

Senator METZENBAUM. Jim McClure thinks that is pretty young. [Laughter.]

Senator MCCLURE. You are right.

Mr. POTTER. Well, I am not telling the Social Security Bureau that, though.

But I do not remember ever prices taking jumps like they did in the last two or three weeks. Some of my suppliers jumped as much as six or seven cents a gallon in one night. But now, prior to that those same suppliers had dropped two or three cents a gallon.

So a poor old country boy like me cannot tell you anything except—I am like Will Rogers when he said what he reads is in the papers—what I read on the invoice from Exxon or from those other suppliers. And I really cannot comment as to why these prices are increasing, except some of the—in my case, some of the mandates that are being put on us by EPA are going to be very stringent.

In our market, our small margin that we have in the gasoline market, we are going to be hard-pressed to meet those without increasing our gasoline prices.

Senator METZENBAUM. Mr. Stanton, do you want to address yourself to that same question?

Mr. STANTON. Yes, Mr. Chairman. I brought with me all of my dealer tankwagon price changes for the last eleven years. I went through them in the last two or three days, and at no time since 1977 have we seen this much of an increase in this short of a period of time.

The largest increase that I saw, according to my records, was 30 cents in a year's time. I do not recall the year.

Senator METZENBAUM. Let me just ask you one last question and then turn it over to Senator McClure. When your supplier boosts its price, are you required to follow suit? Do you have to go up?

Mr. STANTON. Economically, yes, sir.

Senator METZENBAUM. But otherwise you are not obligated?

Mr. STANTON. No, we are not required to.

Senator MCCLURE. You have to stay in business.

Senator METZENBAUM. If prices were going up so much anyway, why did you not add a couple of cents for yourself?

Mr. STANTON. Well, I do not want to alienate my customers. I am in a very competitive business, as you have heard time and time again. And to give you a small example, Mr. Chairman, when

prices were going up a nickel at a time every other day, I was able to, because of reserves I had in the ground, keep my street price down four cents at one time.

Now, those two days that I was down four cents, I picked up almost an additional thousand gallons a day in sales. Now, I would be crazy not to stay there if I could afford to do that.

And to pass it along to anybody in the industry today would be catastrophic financially for that business. You have to maintain a competitive stature.

Senator METZENBAUM. What do you feel your net profit per gallon is after paying your help?

Mr. STANTON. After expenses, mine personally?

Senator METZENBAUM. Yes.

Mr. STANTON. Six cents.

Senator METZENBAUM. Senator McClure.

Senator MCCLURE. Mr. Chairman, obviously we are dealing with a very confused picture. I am kind of like Mr. Potter. I am just a country boy, too, and I have a little trouble finding out, understanding all that I read, let alone trying to understand movements about which I only see the conclusions and none of the explanations.

I am obviously concerned when there are charges made that there is collusive practice. Mr. Stanton, you have said that you have a competitive business and you have to meet the competition. And yet, Mr. Rothschild says that on the other end of the chain the oil companies have no competition and they do not have to meet any.

Now, you may both be right, but there is something in that that bothers me just a little, in saying that one end of the business is competitive and the other end is totally not.

I am told on the part of some that if one oil company raises prices and another oil company also raises prices, that that is anti-competitive. But Mr. Stanton, if I see you raising prices after somebody else has raised their prices, I am told that you are only reflecting the costs of your operation, the cost of your product.

I am a little confused at that difference of judgment based upon who it is that is doing it.

Mr. Rothschild, I am confused in your statement when you are saying that the oil companies are forcing people to buy higher octane gasoline. I thought Mr. Stanton said it was very competitive and they did not buy it if they did not want it, and if it cost too much they did not buy it.

I am confused when I see those kinds of conflicts in statements. I will ask a direct question, Mr. Rothschild. You have indicated that the oil companies are having no trouble finding inexpensive octane enhancers. My understanding is that they substituted for lead the high end aromatics that come out of the top end of the barrel and they are very much more expensive than the tetraethyl lead.

What is the source of your information that they have inexpensive additives that they are using instead?

Mr. ROTHSCHILD. Well, there are different things you can do to raise octane. Lead may be the cheapest, but we are talking about in a relative sense of what is available after you deal with lead.

I did not reference lead. I did not think I referenced a lead comparison, number one.

And number two, I never said totally not competitive; and I never said forcing people to buy high octane gasoline. What I said was that, through high intensity advertising, they are promoting——

Senator MCCLURE. All right, promoting.

Mr. ROTHSCHILD. Promoting, very, very effectively promoting people, and giving people the sense that it is better for their cars. Well, it is not better if your car does not require it. It is absolutely not better.

Senator MCCLURE. Then I would assume that your response to that would be to have better educated consumers and that you are dedicated to doing that.

I was looking at page 13 of your prepared statement: "Refiners have had no significant problems in manufacturing fairly inexpensive lead substitutes."

Mr. ROTHSCHILD. Right.

Senator MCCLURE. Now, if that is not a direct——

Mr. ROTHSCHILD. I did not say less expensive than lead. I said "fairly inexpensive substitutes," and they are not very expensive when you consider the fact that the difference between 87 regular and 93 octane is something on the order of 15 cents a gallon and the cost of raising the octane is no more than five cents a gallon.

Senator MCCLURE. All right. Where did you get your five cent figure?

Mr. ROTHSCHILD. I get it from various trade press accounts. I will leave the study that we based it on with the Committee and I would be happy to substitute it.

Senator MCCLURE. If you would, I would be pleased, because the last figures that I saw, the high end aromatics take 15 percent of the barrel.

Mr. ROTHSCHILD. First of all, the companies that produce the high end aromatics are not buying them on the open market. You cannot confuse open market purchases of products that are listed in, let's say, Octane Week with the fact that they produce them internally. It is an internal cost.

Senator MCCLURE. I understand that.

Mr. Lichtblau, what is your understanding of the substitutes for——

Mr. LICHTBLAU. Well, I do not think they are all that cheap. Take the butane. In order to reduce the vapor pressure, you have to take the butane out of the gasoline. That means you have to substitute it by something else, which is definitely much more expensive than butane.

So there are cost increases that are generally accepted by everyone, including the EPA, which has now required these reductions in vapor pressure, that it will cost two, three, four cents a gallon more during the summer months. So there is a cost when you improve the quality of the gasoline, there is no question about it.

Also, you have to realize that U.S. refiners are operating very close to their capacity on gasoline and gasoline demand has been rising steadily for the last several years. It is expected to rise again this year and, while there is no shortage, there is somewhat of a

capacity constraint when you operate at 95, 98 percent of capacity, which is one of the factors why gasoline prices have been rising for some time.

If there were a substantial excess capacity, as there was a few years ago, I do not think you would see that increase.

Senator MCCLURE. Mr. Chairman, I want to correct one statement I made just a moment ago. I said 15 percent penalty. That is the overall energy penalty, not just the barrel cost of the high end aromatics. It is roughly divided seven to eight percent decreased total product from the barrel and seven or eight percent increase in energy consumption in the internal combustion engines because of lack of efficiency——

Mr. LICHTBLAU. Yes.

Senator MCCLURE [continuing]. Introduced by lower octanes.

Mr. Rothschild, if I understand your premise—and I am not trying to put words in your mouth; I am trying to summarize—you have long believed that oil companies are engaged in monopolistic practices in pricing and marketing their product, is that not correct?

Mr. ROTHSCHILD. I have expressed that view from time to time, yes.

Senator MCCLURE. And you now see the Exxon Valdez instance as an excuse by them to further that practice?

Mr. ROTHSCHILD. I think I said that, if you have to look at it historically and you look at what happened, let us say, in 1988, when crude prices came down, you have to give me some explanation as to why gasoline prices did not follow. You also have to explain why——

Senator MCCLURE. I am not trying—the reason I summarized was to try to limit the amount of time spent.

Are you not really on the horns of a dilemma, that if you charge them with monopolistic practices that are rising, causing the rise in price of oil and gas, would you not prefer to have that focus on their underlying conduct, rather than the *Exxon Valdez* incident?

Mr. ROTHSCHILD. All I am saying is I think the Exxon Valdez incident provided them with an opportunity. I do not think the Exxon Valdez incident created it. I think it provided them with an opportunity, and in markets where there is limited competition that opportunity, as we can see, has allowed them to raise prices significantly.

I mean, there are places that are not even served by company oil where the gasoline wholesale and retail prices went up on the order of 10, 15, 20 cents a gallon.

Senator MCCLURE. And you take that as evidence of monopolistic practice and not as evidence of the fact that there is something else that caused the price to rise?

Mr. ROTHSCHILD. I think that some of it is going to—I said in my statement, I think some of the price increase is due to other factors, certainly not the way it has gone up and certainly not all of it.

And finally, I do not believe it is monopolistic. That is one company. These are a few companies controlling the market. As long as we agree it is a shared monopoly, yes, I think there is plenty of evidence. There has been evidence over time that that is the case.

Senator MCCLURE. Mr. Lichtblau?

Mr. LICHTBLAU. I would just like to make one comment, that there has been a lot of reference here that in 1986, when crude oil prices dropped sharply, gasoline prices did not follow. This is factually incorrect. At the end of 1986 gasoline prices were about 36 cents below what they had been at the end of 1985. To me that is a drop.

Crude oil prices dropped somewhat less than this, in fact. If you take December 1985 and December 1986, the average U.S. gasoline price was 36 cents lower in December 1986 than a year earlier, while crude oil prices were about 26 or 27 cents lower.

So clearly, with a lag—it did not happen immediately, but when the big price crash came in OPEC in early 1986, over time with a few months lag it was transmitted to consumers in the form of substantially lower prices.

Senator MCCLURE. Mr. Lichtblau——

Senator METZENBAUM. I just wanted to point out, Senator McClure——

Senator MCCLURE. Surely.

Senator METZENBAUM [continuing]. That Petroleum Intelligence Weekly make it very clear in their report that consumers did not get the benefit of those lowered prices. And I will introduce that statement in the record at this point.

[The information follows:]

FOUNDED 1961. Vol.XXVIII No. 15 April 10, 1989

PETROLEUM INTELLIGENCE WEEKLY

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Unexpected Rebound Propels Opec Up To 20-Million BD

In contrast to earlier expectations, Opec crude oil production actually turned around and climbed higher in March, rebounding back to over 20-million barrels a day. Furthermore, the rising wellhead flow is fairly close to Opec's quota definition of supply, since member countries moved relatively little oil — probably 500,000 b/d or less — into storage last month and also took some out, according to PIW soundings. Saudi Arabia and perhaps one or two other producers built inventories last month, while Iran seems to have reduced its stocks overseas. The 350,000 b/d jump in Opec's March wellhead crude oil production brought the first-quarter average to just over 20-million b/d, and after adjusting for Opec's quota definition, the group is about 1-million b/d above its 18.5-million b/d quota. Under the Opec definition, only oil exports, domestic consumption, and sales from overseas stocks count in production.

The surprise jump comes from just four countries. Iran, Kuwait, the United Arab Emirates and Nigeria each boosted their wellhead production in March, putting them all above their Opec quotas. In the case of the UAE, previous indications that it would gradually cut output over the first quarter have failed to materialize, as Abu Dhabi has consistently reduced sales to Western customers only to turn around and sell extra oil on the spot market or to Far East clients. Kuwait's rising flow seems to be showing up as increased delivered crude oil sales to the US in April (p3), and Iran appears to be maximizing its expansion in production capability (p5). Nigeria's burst of March production reflects the intensified demand for light crudes in the Atlantic Basin. Among Mideast producers, Saudi Arabia alone reduced its production in March.

Oil Consumers Get Little Benefit From 1988 Price Drop

Final consumers got virtually no benefit from last year's crude oil price decline. Instead, oil company downstream margins and government treasuries reaped most of the gain, PIW finds. When contrasted with the surprising growth of oil demand last year, this indicates that the boom in consumption was not the result of low prices but reflected other special influences, such as the more direct link between oil use and economic expansion (PIW April 3,p1). Similar results occurred in 1986, when final consumers received only half of the gains from the collapse in oil prices (PIW Oct.13'86,p1) and refiner margins increased substantially. The ability of refiners to capture most of the spread between crude feed prices and final retail levels enabled the downstream sector to reach record profit levels in 1987 and 1988.

From the oil price peak in the summer of 1987 until November 1988, delivered crude costs to major industrial countries dropped a broadly similar 35%-39% in local currency. Yet, final consumer prices for key light products hardly changed in high-tax countries in Europe and the Far East and went down only slightly in countries with low excise taxes on gasoline, like the US. In Germany and Japan,

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final consumer prices for gasoline and gas oil actually went up (see table). Oil taxes in Japan were increased in 1988, further enabling the government to gain at the cost of final consumers. In the US, where consumer taxes are lower and product markets are more competitive than in most other industrialized countries, lower crude oil prices were passed on to final consumers, but only fractionally. Relatively tight product markets in the US also allowed most of the gain from lower crude prices to accrue to refiners.

In contrast to light products, residual fuel oil prices proved more responsive to crude price changes, but here again the drop was minor compared with the decline in crude costs. Only 40% of the crude price fall in the US and Germany and a meager 20% in Japan was passed on to fuel oil customers. Most countries have minimal taxes on fuel oil to ensure the global competitiveness of domestic industries; hence residual fuel prices tend to adjust more quickly to crude price changes than other products do.

RECENT CRUDE IMPORT COSTS AND FINAL CONSUMER PRICE TRENDS IN KEY COUNTRIES

		Japan				Germany				US		
		Crude (oil)		Gasoline	Gas Oil	Crude (oil)		Gasoline	Gas Oil	Crude (oil)	Gasoline	No. 2 Oil
Period		$/Bbl	Yen/Bbl	——$/Gallon——		$/Bbl	DM/Bbl	——$/Gallon——		$/Bbl	——$/Gallon——	
1987	3Q	18.33	2,451	3.26	1.03	18.94	36.42	2.10	0.88	18.00	0.90	0.82
1988	Jan.	18.11	2,311	3.48	1.12	17.16	28.36	2.21	0.75	14.92	0.95	0.89
	Oct.	13.32	1,722	3.53	1.10	12.98	23.88	2.07	0.80	12.32	0.96	0.79
	Nov.	12.09	1,491	3.52	1.09	12.90	22.75	2.21	0.88	12.05	0.95	0.80
	Dec.	12.26	1,515	3.40	1.05	14.87	26.08	2.20	0.74	13.43	0.93	0.83
1989	Jan.	13.28	1,689	3.34	1.02	16.62	28.44	2.38	0.84	15.32	0.92	0.88
	Feb.	15.07	1,935	3.34	1.02	16.30*	30.04	2.43	0.79	15.60*	0.93	0.89
% Change												
3Q'87–Nov.'88		−34%	−39%	+8%	+6%	−31%	−30%	+5%	+9%	−35%	−8%	−2%
Nov.'88–Latest		+25	+30	−5	−6	+25	+32	+10	+14	+29	−2	+11

*Estimate. Source: International Energy Agency.

East Of Suez Bunker Use Slowing After Heady Growth

The rapid growth of bunker fuel oil demand in the Asia-Pacific region seems on the verge of slowing somewhat from the hectic pace of recent years, but a steady expansion may well extend into the 1990s. Singapore has consolidated its leadership position and the Mideast Gulf is emerging as a thriving market, while Japan has dropped out of the picture and the future role of the US West Coast as a supplier is clouded. Singapore's phenomenal demand growth is expected to flatten out, after hitting a record of over 10-million tons (175,000 barrels a day) of bunker sales last year. Mideast ship-to-ship bunkering operations are also booming, due in part to higher Mideast production levels. While bunkering of tankers is the primary focus, a number of container ship lines have shifted purchases to the Mideast, mostly outside the Gulf offshore Fujairah, to take advantage of low prices. Offshore Mideast sales have been as high as 1-million tons a month (220,000 b/d) during peak periods.

Singapore is the primary bunkering port in Southeast Asia, but it may be able to sustain only moderate further expansion, with some observers predicting that it is reaching its physical capacity limit, according to a PIW on-the-spot assessment. Major oil companies in Singapore are reasserting their dominance of the local bunker market, regaining lost ground and now accounting for 60%-65% of sales. The market has surged since decontrol of bunker prices in 1985, with annual growth averaging 15%-20%. Singapore's location, large refining capacity, 24-hour barge services and growing storage capacity have all spurred bunker sales. But wharfs and other facilities are now increasingly crowded, requiring new investment to sustain further growth.

The emergence of floating bunkering operations in the Mideast was originally prompted by the Iraq-Iran war, but they have now taken on a life of their own. While likely to grow at a healthy pace, they face supply constraints as Gulf refineries add sophisticated upgrading capacity and as runs at export-oriented plants are restrained by Opec quota limits. However, the bunker business is attracting new players, and among the more important is possibly Iran's NIOC. With its Abadan refinery due to start up soon, Iran could take up the slack left by other fuel oil suppliers.

While continued growth is expected in US West Coast bunker sales and fuel oil exports to Pacific Rim countries, Japanese bunker volumes have plunged. Due to

Senator METZENBAUM. I did not mean to interrupt you.

Senator MCCLURE. Surely.

According to the Energy Information Monthly Energy Review, December 1988, prices dropped from January 1986 of 89.3 cents to November of that year 53.2 cents.

Senator METZENBAUM. Is that the retail price?

Senator MCCLURE. That is the refiner sales price of petroleum products to end users, excluding taxes.

And in my own recollection, I do not recall exactly the drops, but I do remember a precipitous decline in the price of gasoline. How precipitous it was is subject to interpretation, I guess. But I remember prices of gasoline going down and I remember welcoming them.

Just one final observation, Mr. Chairman. It is a little difficult to make comparisons between price movements now and price movements in 1973 and 1979, because we had price controls on petroleum and gasoline products in those other periods of time and therefore the government was involved.

One thing we did not have this time was gas lines. One thing we did not have this time was parking their cars because they could not find any. Maybe that is a product of the fact that it was a marginal interruption in a short period of time.

Maybe it is also a result in part of the fact that the government was not allocating supplies. And I am sure that if the government had been allocating a shortage of supply in California, you would have had a much worse time in California than we had, because there is very little out there that the private sector does so poorly but what government can do it worse.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Senator McClure.

And thank you to each of these witnesses.

The Chair wishes to announce this hearing is about to conclude, but there are some matters that came up today that causes the Chair to think that it may be necessary for my Antitrust Subcommittee to inquire into. But suffice it to say that for the Energy Regulation and Conservation Subcommittee our hearing for today is concluded, and I thank all of those who participated.

[Whereupon, at 1:14 p.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement by the Honorable Toby Roth
to the Senate Subcommittee
on Energy Regulation and Conservation
on
The Gas Price Increase
April 17, 1989

Mr. Chairman, I am glad to have this opportunity to submit a statement on this very important issue. I applaud your subcommittee for holding hearings on the gas price hikes. The price increase we have seen recently is the largest in the history of United States gasoline market. In just 21 days the retail price for gas shot up 10 cents. This 10 cent increase, alone, would cost a rural family of four an extra $161 a year. The farmers, families and tourist-related businesses in Northeast Wisconsin are angry about this increase, and I'm angry too.

I simply do not believe that these price hikes are solely due to the Exxon Valdez disaster. In November a barrel of crude oil cost $12, now it costs $20. The industry claims that price increases were already on the way when the Valdez ran aground. People are already mad because of Exxon's role in the spill. However, if the industry -has used this disaster to artificially raise prices then tough questions will have to be answered. Further, the industry now claims that prices will level off and remain stable through the summer.

There are obvious suspicions when an industry can predict that "prices will level off" in the wake of a disaster.

As the Vice Chairman of the House Travel and Tourism Caucus, I would also like to express my concern about the possible affects that a gas price increase would have on the tourism business. Tourism is this nation's second largest employer, and many feel that by the 1990's it will be the largest. If we are willing to recognize this fact, then we must be prepared to protect the market.

In Wisconsin we are looking forward to what promises to be the most successful tourist season on record. With Memorial day just around the corner, many Americans are planning for a vacation. The fact is that fewer people will be able to take long car trips if gas prices remain so high. Nearly 80% of the visitors who come to the Great Lakes region come by car. On the one hand, this fact shows how accessible our area is to travelers and on the other, it shows how vulnerable we are to gas price increases.

Wisconsin already pays a premium for gasoline -- the gas tax is the highest in the country at 20.9 cents per gallon. An added 10 cent increase places an extra burden on our state.

Some Members of Congress have been advocating an increase in the gasoline tax. This proposed increase ranges from 10 cents to $1.00 per gallon. I have opposed these measures for precisely the reasons that we have on our hands now. The American people are mad -- and rightfully so. People in rural areas that travel many miles just to go to work simply cannot afford to pay more for their gasoline.

It is on their behalf, then, that I salute this inquiry and applaud the efforts of this subcommittee.

NCPR NATIONAL COALITION OF PETROLEUM RETAILERS

Jonathan W. Cuneo
Legislative Counsel
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Prepared Statement

of

Jonathan W. Cuneo

Legislative Counsel

National Coalition of Petroleum Retailers

Before the

Subcommittee on Energy Regulation and Conservation

of the

Senate Committee on Energy and National Resources

April 17, 1989

D.C. OFFICE: 1401 NEW YORK AVENUE, N.W. • SUITE 740 • WASHINGTON, D.C. 20005

Mr. Chairman and Members of the Subcommittee:

I am Jonathan W. Cuneo and I practice law in Washington, D.C. My background is in antitrust and trade regulation, and I am the legislative representative of the National Coalition of Petroleum Retailers, Inc ("NCPR"). NCPR is a membership organization composed of state associations of petroleum retailers. Among NCPR members are state associations in some of the largest states: New York, Texas, Pennsylvania, Michigan, New Jersey, Georgia and Connecticut.

In the past several weeks, the country has experienced across-the-board gasoline price increases of tremendous proportion. The price increases are not confined to areas dependent upon Alaskan oil or to the company involved in the Valedez spill. Rather, they are coast-to-coast and appear to involve every grade of every major refiner. For example, in the period from March 7 through April 7, 1989, the average wholesale price increase to Georgia independent branded dealers for regular unleaded gasoline was 14.41 cents per gallon -- a one month increase of 26.1%! For premium unleaded, the one month increase was 14.41 cents per gallon -- an increase of 21.3%! Our Georgia association understands that another, subsequent increase has pushed these figures past 20 cents per gallon. A spokesman for

the American Automobile Association has stated that the double digit increase is "the largest one month increase I could find since AAA has been doing gas prices."

What accounts for a single month increase of 20-30%? There is no obvious or apparent answer. Clearly, service station dealers do not have the answer. The New York Times has reported that "So far, this year, . . . the increases in retail prices have lagged behind the advances in wholesale prices." Ultimately, of course, independent service station dealers will have no choice but to pass on wholesale price hikes to the consumer.

The answer lies at the refiner level. Without access to the pricing documents of the majors, no one, except the refiners, knows the answer to this question of paramount national significance that directly affects every motorist. A few things are clear, however. Industry analysts blame the price explosion on a perception that crude oil prices will rise and the anticipated increase in summer automobile travel. The explanation that all of the competing refiners reached the same realization at the same moment raises questions about the competitive functioning of the market.

Competitive questions have surrounded the major oil companies for much of the century. Many of these questions remain unanswered. At times of problems or crisis, the majors have frequently hiked their prices about the same amount at about the same time. The results have been predictable -- little price competition for Americans and record profits for the major oil companies.

There is evidence that competitive problems worsened significantly due to the mergers and acquisitions in the past decade. There is an alarming increase in the spread between the cost of crude and wholesale prices of gasoline. This phenomenon strongly suggests the possibility of noncompetitive pricing. It suggests that the majors have the ability to restrict their output -- lowering their costs while raising their prices -- to achieve extraordinary profits at the expense of the motorist. This month's National Petroleum News noted that:

> Refined petroleum product prices are often living a life of their own, nonchalantly ignoring crude oil price. Take gasoline. While crude prices dropped much of last year, retail and wholesale prices didn't, or at least not as much. There were times, in fact when gasoline prices rose while crude oil prices fell. (Emphasis added).

According to Ronald H. Schmidt, an economist at the Federal Reserve Bank, who has expertise in the oil industry, mergers and acquisitions have reduced competition in the production of gasoline, "allowing refiners to boost profit margins when crude

oil costs fall." It will be interesting, indeed, to study the profitability of major refiners for the first and second quarters of 1989.

What can Congress do? First, it can insist on the facts. Congress and the federal antitrust enforcement authorities are uniquely suited to determine the real causes of the increase. This is a national problem best addressed at the national level. If necessary, the federal authorities should use their compulsory process powers to obtain the pricing documents that will show the true causes of this increase. It would be a great national service for Congress to expose whether the increases in gas prices are due to cost-justified business reasons, price leadership or even actual collusion.

Past attempts to look into the industry, such as the ill-fated FTC case of the late 1970's, have been frustrated by the magnitude of the undertaking, becoming engulfed in a mass of documents. The recent price increases provide a small window of opportunity to gain insights because the period of time covered is short and the facts relatively straightforward.

Second, Congress should act to protect competitive forces that now exist. By shielding motorists from the full effect of the wholesale price hikes, independent retailers have <u>already</u> performed an important function. You have before you S. 421, the

"Fairness in Bargaining Act," which would protect independent retailers from losing their franchises at renewal time through conditions that are not fair and reasonable. Without this legislation, the major refiners will be able to dominate the delivery system from extraction of crude to pumping of the refined product. Maintaining a competitive market through all stages of delivery is essential. Immediate passage of S. 421 will not guarantee a competitive market at all stages, but it is an important step in prevent further erosion of competitive conditions.

Thank you.

Why Gasoline, Crude Prices Aren't Tracking

Refined petroleum product prices are often living a life of their own, nonchalantly ignoring crude oil price. Take gasoline. While crude prices dropped much of last year, retail and wholesale prices didn't, or at least not as much. There were times, in fact, that gasoline prices rose while crude prices fell.

An economist at the Federal Reserve Bank of San Francisco, Ronald H. Schmidt, analyzed this. NPN also crunched some numbers and came to similar conclusions. Schmidt, whose familiarity with the oil industry stems from his former work at the Federal Reserve Bank in Dallas, notes that some temporary disruptions—such as a major fire at a Shell Oil refinery and hurricane damage in the Gulf of Mexico—helped cause gasoline prices to diverge widely from crude prices last year.

Beyond this, however, Schmidt says long-term trends contributed most to the "weakening link between crude oil and gasoline prices," namely, total refining capacity has fallen in recent years, and mergers and acquisitions have reduced competition in the production of gasoline, "allowing refiners to boost profit margins when crude oil costs fall."

There have been times when gasoline prices didn't follow crude prices, but in general the two moved in the same direction. In contrast, between February and October 1988, crude prices fell nearly 24% while retail prices of unleaded gasoline actually rose, Schmidt says. Wholesale prices rose too.

The FRB economist says between 1983 and 1986, a 10% change in crude prices led to a 5.5% change in retail unleaded gasoline prices, while in the 1987-88 period, a similar change in crude prices led to only a 1.7% change in the price of retail unleaded gasoline.

NPN studied the spread between crude prices and gasoline retail prices from 1985 to late last year and between crude prices and refiner gasoline prices direct to end users. Clearly, the spreads increased significantly last year. For example, the spread between crude and retail prices averaged 55.9¢/gal. in 1985, 58.4¢ in 1986, 53.9¢ in 1987, and 60.7¢ in 1988 (10 months, latest prices available from the Energy Information Administration). The 1988 spread was 5-7¢/gal. higher than during typical recent past years. The year 1988 was exceptional because crude prices plunged steeply and product prices took a while to catch up. No comparable reason existed in 1988.

Similarly, the spread between crude and refiner prices to end users, another price series tracked by EIA, averaged 27.4¢/gal. in 1985, 27.7¢ in 1986, 24.4¢ in 1987, and 31.4¢ in 1988. This is represented in the accompanying graph.

In other terms, the economist points out that in the pre-1987 period, a $15 crude oil price eventually would yield a retail price for unleaded gasoline of 84¢/gal. In the post-1987 market, the same price of crude oil would yield a retail gasoline price of 94¢/gal.—a 10¢/gal. margin increase.

Now for the reasons.

Operable refinery capacity in the United States has fallen from nearly 19-million b/d in 1981 to under 16-million in 1988. The number of refineries dropped from 303 in 1981 to 182 in 1987. Meanwhile, lower gasoline prices and economic growth caused increased consumption of gasoline and some other refined products.

U.S. refiners have been using more and more of their operable capacity, an average of as much as 87% one month last year. High operating rates take pressure off refiners to drop product prices because they're selling practically all they can make.

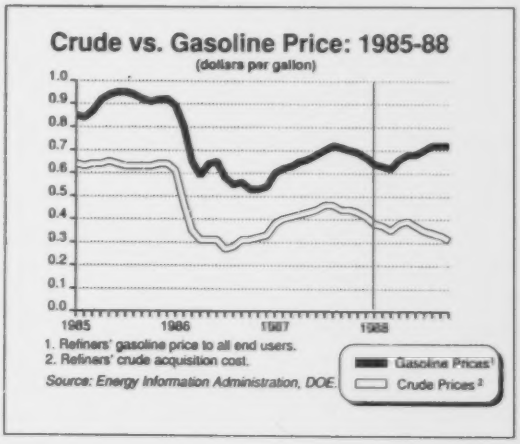
Refineries don't spring up overnight. Economist Schmidt says, "The growing ability of refiners to keep gasoline prices high in the face of falling crude oil prices rests firmly on the high fixed cost of building new refining capacity, which serves as a barrier to entering the refining industry."

He didn't mention, but could have, that environmental regulations are making refinery building and expansion more difficult, if not impossible, in some areas.

Schmidt sees refinery price-setting power in the near term getting stronger rather than weaker. "Domestic oil companies and oil exporting countries will respond to growing capacity shortages by expanding downstream refinery operations. This should serve to temper refiners' price-setting powers over time."

Increased refinery capacity isn't going to happen soon. Even if excessive margins caused investments in new refining capacity right now, it would take some years before the products became available.

Local conditions may vary, of course, but, in general, refined product prices will most likely continue to provide an opportunity for higher wholesale and retail margins for some time to come.



1. Refiners' gasoline price to all end users.
2. Refiners' crude acquisition cost.
Source: Energy Information Administration, DOE.

American Petroleum Institute
1220 L Street, Northwest
Washington, D.C. 20005
202-682-8100

Charles J. DiBona
President

April 24, 1989

The Honorable
Howard M. Metzenbaum
Chairman, Subcommittee on Energy Regulation
and Conservation
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In my letter to you of April 14, 1989, I indicated that I would be pleased to supply a written statement for your hearing regarding recent increases in the prices of petroleum prices. I am enclosing that statement for inclusion in the record.

You will note the information we have is consistent with the testimony of Mr. John H. Lichtblau, the Department of Energy, and other witnesses who observed that changes in product prices are due to a number of factors. The oil spill in Alaska is only one limited aspect of the overall pricing situation.

I hope the information in this statement will be of use to the Committee.

Sincerely,

Charles J. DiBona

Statement of The American Petroleum Institute
to the Subcommittee on Energy Regulation and Conservation
of the United States Senate Committee on
Energy and Natural Resources

April 24, 1989

The American Petroleum Institute (API), an association of over 200 corporate members engaged in all aspects of the oil and gas industry, including exploration, production, refining, transportation and marketing, is pleased to submit this statement.

The Subcommittee has requested information pertaining to recent increases in petroleum product prices, particularly motor fuel prices. API's response is based completely on matters of public record, historical data, and general economic considerations. API does not have information on specific current market situations or on the pricing decisions of individual companies.

A number of factors appear to have affected the costs of producing petroleum products over the past few months. The most important probably is an increase in the price of crude oil, the principal input in the production of petroleum products. This increase appears to have resulted mainly from an agreement by the members of OPEC last fall to reduce their collective production by some three million barrels per day, to 18 1/2 million barrels per day. According to press reports, OPEC members generally appear to have adhered to the agreement. In consequence,

according to published data sources, the refiner acquisition cost of crude oil rose by some five dollars per barrel from November of 1988 to March 1989, and has since risen another two dollars or so per barrel. At 42 U.S. gallons per barrel, this amounts to a crude oil cost increase of some 16 to 17 cents per gallon over the November to early April period.

On the demand side, vehicle miles traveled and other economic data suggest that demand for transportation fuels continues to rise in the U.S. Recently, we have moved from the winter months into the beginning of the spring driving season. Heightened demand for transportation fuels increases U.S. refinery capacity utilization towards its limit and hence increases the cost of motor fuel supplies.

Government regulation in the U.S. and Europe appears to have impacted motor fuel costs also. The U.S. Environmental Protection Agency recently promulgated a rule requiring a reduction in the summertime volatility of gasoline; because of the logistics of gasoline supply, refiners already have begun adjusting to the new rule. According to the EPA's own data, the rule raises the costs of producing gasoline by a few cents per gallon. Also, various northeast states are seeking to reduce gasoline volatility even further and, insofar as these efforts prove successful, costs of products would rise even further.

In Europe, government regulation has forced refineries to reduce the lead content of gasoline and hence to seek other, more expensive means to obtain desired octane levels. As Europe is a principal source of U.S. gasoline imports, this regulation also has some impact on the costs of the U.S. gasoline supply.

Finally, the recent oil spill in Alaska probably had some short term impact on the gasoline market. First of all, the spill resulted in a partial closing of the Port of Valdez for several days, temporarily reducing supplies to the West Coast and to other destination markets. This in turn may have induced panic buying in some markets. However, the supply situation in Alaska has returned to normal so, hopefully, the market impacts of the spill probably are largely behind us.

API has observed in the past that product price changes usually lag those of crude oil. Recent data on crude oil and product prices suggest that such lags have occurred over the past several months; crude prices have moved upwards since November, after the OPEC agreement to reduce production, and product prices have risen over the past several weeks. Although the crude price increase appears to have been the single most import phenomenon affecting petroleum product markets, the other factors identified -- demand increases, new regulatory requirements in the U.S. and abroad, and the Alaskan oil spill -- probably also have had some impact.

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DEPARTMENT OF ECONOMICS

SANTA BARBARA, CALIFORNIA 93106

April 17, 1989

Chairman, Regulation Subcommittee
Energy and Natural Resources Committee
U. S. Senate
Washington, D. C. 20510

Dear Senator:

California State Controller Gray Davis is reported in today's L.A. Times as testifying before your committee concerning the important issue of competition in the OCS oil lease market, and in petroleum product markets. My extensive academic research in this industry does not support Mr. Davis's conclusions.

A copy of my letter to Mr. Davis, together with a copy of a paper published in the October 1983 issue of The Energy Journal, are enclosed.

I hope that your Subcommittee will consider objective scholarly research in the area of oil industry competition before legislation is introduced.

Sincerely yours,

Walter J. Mead
Professor of Economics

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DEPARTMENT OF ECONOMICS — SANTA BARBARA, CALIFORNIA 93106

April 17, 1989

Mr. Gray Davis
Office of the Controller
State of California
Sacramento, Calif.

Dear Mr. Davis:

Today's Los Angeles Times reports as follows:

> California Controller Gray Davis will tell Congress today that "we should not even think of leasing" the federal waters off California for oil exploration "until the monopoly power of the major companies is broken."

At UC Santa Barbara, we have conducted the most extensive available studies of competition for federal OCS oil and gas leases to determine whether competition is effective in that market. After about five years of analysis covering the record of leasing since 1954 in the Gulf of Mexico, we concluded that competition was effective and that the federal government had received at least "fair market value" for the leases. The evidence supports a conclusion opposite from your statement--bidders probably paid too much for the leases, and large firms paid more and earned lower rates of return than smaller firms. There are too few leases offshore from California to do the same analysis, but we have no reason to think that conditions differ in the California OCS. I am enclosing a copy of a paper that summarizes our findings.

The Times also repeats your charges that West Coast crude prices are "below fair market value", that major oil companies "charge more for gasoline" and "make higher profits" on the West Coast. My own professional studies of competition is the petroleum industry indicate that this industry is effectivly competitive in all of its markets. I know of no objective economic analysis that supports your conclusions.

If you and your staff would like to review our research in this area, I would be glad to meet with you and discuss these issues in an objective manner.

Sincerely yours,

Walter J. Mead
Professor of Economics

The Rate of Return Earned by Lessees under Cash Bonus Bidding for OCS Oil and Gas Leases

Walter J. Mead, Asbjorn Moseidjord,** and *Philip E. Sorensen***

INTRODUCTION

The remaining oil and gas reserves and resources of the Outer Continental Shelf (OCS) represent one of America's largest publicly owned assets. Through 1980, OCS oil and gas leases had produced $62.8 billion in gross revenue and $41.3 billion in bonus, royalty, and rental payments to the federal government (U.S. Geological Survey, 1981).[1]

Policies and procedures for managing OCS oil and gas resources were established by Congress by the Outer Continental Shelf Lands Act of 1953. This act provides for leasing of OCS lands based on cash bonus bidding with a fixed royalty rate of not less than 12.5 percent of wellhead value (or quantity), or royalty bidding with a fixed bonus payment. Through 1978, nearly all leases were issued via cash bonus bidding with a 16⅔-percent royalty rate.

Consumer activists, led by a lobbying group called Energy Action, have asserted that bidding under this leasing method has not been effectively competitive and that big companies have enjoyed an unfair advantage in the lease sale market. This advantage is alleged to arise out of the fact that bonus bidding, as practiced, requires a heavy "front-end payment" as a

The Energy Journal, Vol. 4, No. 4 October 1983
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This research was supported by U.S. Geological Survey Contract No. 14-08-0001-18678. The views expressed are those of the authors.

*Department of Economics, University of California at Santa Barbara, Santa Barbara, Calif. 93016.

**Florida State University.

1. The social value of OCS production is even greater than indicated here because price controls on both oil and gas artificially depressed the wellhead value of production.

means of deciding (1) who is to be issued a lease and (2) how much is to be paid to the government. In response to this criticism, Congress enacted the Outer Continental Shelf Lands Act Amendments of 1978. In his endorsement of the proposed amendments, President Carter asserted that they would "enhance competition [and] ensure a fair return to the public" (U.S. President, 1977, p. 56). The 1978 amendments included the goal to "insure the public a fair and equitable return on the resources of the Outer Continental Shelf (McDonald, 1979, chap. 3). Most economists would agree that the primary goal of leasing policy should be to maximize the *in situ* present value of the resources and for the government to collect the full amount of this economic rent.

Under guidelines established by the 1978 legislation, Congress specified that bidding systems other than conventional cash bonus bidding with a fixed royalty must be used for not less than 20 percent and not more than 60 percent of the total area offered for leasing each year during the first five years following enactment of the legislation. Prior to the end of 1983, Congress will presumably reexamine the wisdom of mandated departures from cash bonus bidding. This paper offers analytical results that shed light on the performance of the established cash bonus bidding system.

We have computed the aggregate internal rate of return (IRR) earned by lessees of leases issued from 1954 through 1969. Our IRR analysis rests on competitive market assumptions. A necessary implication is that, in the long run, lessees will earn a normal (competitive) rate of return equal to the opportunity cost of investing in OCS leases. Competition and the profit maximization assumption will force lessees to minimize their costs relative to their expected revenue. Conversely, if lessees in the aggregate earn higher than competitive risk-adjusted returns on their OCS lease investments, then an inference may be drawn that competition for OCS leases is inadequate and the government has failed to collect the available economic rent.

In the analysis reported here, we have used the U.S. Geological Survey's lease production and revenue (LPR) data bases. This record includes names of winning bidders, high bonus bids, annual production by petroleum product through 1979, annual rental payments, annual royalty payments, and the total number of wells drilled on each tract by depth and spud-date through 1979. Our sample consists of 1,223 leases issued in the Gulf of Mexico from 1954 through 1969. All sales involved a bonus bid with a fixed royalty at 16⅔ percent of wellhead value. We have cut off our sample of lease sales at 1969 since at least a 10-year record is required to establish a lease's full production potential. In the interest of brevity, we have omitted a detailed explanation of the algorithms used in estimating costs and reve-

nues. They are available elsewhere (Mead, Moseidjord, and Sorensen, 1982, Appendix 1).[2]

Computation of the IRR is based on both known and estimated costs and revenues. On the cost side, exact data are available on all bonus payments, royalties, and rent payments from 1954 through 1979. We have estimated presale exploration costs and postsale exploration, drilling, development, and production costs. Based on the 1979 record of producing leases and using an exponential decline rate of 0.15 (equivalent to an annual 13.9-percent decline rate) for production, we have estimated production and costs through the point of shutdown, assumed to be the year in which the after-tax net present value for each lease is maximized, or 2010 (whichever is earlier). An estimated abandonment cost is applied in the shutdown year. All our past and future costs and product prices are in nominal terms.

On the revenue side, exact data are available on lease-specific production and revenue through 1979. A commercial crude oil price forecast by Data Resources, Inc. (DRI) was the basis of our oil price assumptions through the year 2010 (Data Resources, Inc., 1981, pp. 175–178).[3] The DRI forecast through the year 1995 anticipated a nominal compound annual price increase of 11.27 percent. Using the DRI-estimated rate of increase for the year 1995, we projected this series through the year 2010 to obtain a 10.66 compound annual crude oil price increase in nominal terms from 1981 through 2010.

The predicted price of natural gas fully reflects provisions of the Natural Gas Policy Act of 1978. This legislation calls for complete decontrol of new gas from the OCS by January 1, 1985, but continues controls over "old gas" indefinitely. All gas produced from our sample of OCS leases falls into the category of "old gas" and is subject to permanent price controls as specified in the act.

In the capital theory literature, use of IRR as an investment criterion has been subject to criticism because it fails to consider the merits of large relative to small investment options. Furthermore, an IRR-based ranking of investment projects is not always the same as that which results from using the present-value procedure where the investor's opportunity cost of capital is used as the discount rate.[4]

2. This and other USGS reports by the authors are available through the U.S. Geological Survey, Conservation Division, Mail Stop 620, Reston, Virginia 22092.

3. For additional details on our price scenarios, see Muraoka (1981, pp. 173–178).

4. A computational problem with the IRR methodology is that an internal rate of return may not exist or, if it does, that it may not be unique; a nonconventional cash flow may generate multiple roots. Our computational search method selects the economically meaningful root for the typical cash flow of aggregates of OCS leases. For proof of this point, see Muraoka (1981, pp. 25–28).

To compare single-valued returns from oil and gas leases with single-valued returns to equity in other industries, and to compare subsets of leases (for example, returns on drainage versus wildcat leases), we will utilize the IRR methodology. However, we will also provide present-value estimates given three alternative discount rates, 10, 12.5, and 15 percent. We note that the analytical results are approximately the same using IRR and present value methods.

RESULTS OF THE ANALYSIS

To evaluate the profitability of oil and gas lease investments, we have computed IRRs, both before and after taxes. The IRR estimates reported here are to be interpreted as the rate of return to the equity portion of investments in OCS leases (estimated at 84.4 percent of total invested capital). The discounting method treats 1954 (the first year of OCS leasing) as year zero for all leases. An alternative approach is to treat the year of lease sale as year zero. The former discounting method yields an after-tax IRR estimate of 10.74 percent (see Table 1) while the latter yields 11.84 percent. The discount method chosen in this paper assumes that investments in different lease sales are interdependent. We consider this a reasonable assumption due to requirements of large fixed investments in infrastructure (such as offshore pipelines) and in other area-specific assets, including geological information.

Oil industry profits are subject to ordinary corporate taxes plus a series of taxes unique to this industry. Our analysis considered the following 13 tax provisions:

1. Corporate tax rates
2. Corporate income tax surcharge
3. Cost depletion
4. Percentage depletion
5. Expensing of intangible drilling costs
6. Expensing of dry hole costs
7. Depreciation of tangible drilling costs
8. Windfall profits tax
9. Investment tax credit
10. Capital gains taxes[5]
11. Minimum tax

5. Lacking information on lease transfers between firms, and prices paid in such transfers, we have not been able to consider the capital gains tax impact. However, we know that inclusion of capital gains tax benefits would have the effect of raising our after- tax IRR relative to the before-tax rate.

Table 1. Economic Data for 1,223 OCS Oil and Gas Leases Issued in the Gulf of Mexico, 1954–1969[a,b]

Aggregation Basis	Aggregate Internal Rate of Return		Average Present Value per Lease after Taxes (1954 Base Year) Using Alternative Discount Rates			Number of Leases Issued	Percent Dry Leases	Average Bonus per Lease	Undiscounted Average Gross Value of Production per Lease	
	Before Tax	After Tax	Discount Rates 10%	12.5%	15%				Actual Through 1979	Estimated Through 2010
All 1,223 leases	13.16	10.74	$115,575	$−192,128	$−334,893	1,223.00	61.57	2,228,332	16,698,774	67,592,630
Big 8 firms	12.82	10.37	54,968	−221,873	−349,795	725.35	61.70	2,310,499	16,718,033	65,652,263
Big 9–20 firms	13.62	11.26	218,734	−150,770	−325,116	298.57	63.71	2,354,070	17,230,786	66,290,460
All other lessees	13.63	11.15	181,706	−145,763	−295,255	199.08	57.90	1,740,377	15,830,720	76,615,301
Solo bids	12.24	10.10	14,392	−228,436	−339,515	861.00	63.18	1,848,119	14,580,910	57,832,614
Joint bids	14.74	11.74	356,251	−105,761	−323,897	362.00	57.73	3,132,649	21,736,014	90,806,368
Wildcat leases	12.27	10.04	5,821	−249,045	−364,123	1,109.00	64.65	1,952,202	14,345,622	58,761,152
Drainage leases	18.27	14.59	1,183,260	361,594	−50,534	114.00	31.58	4,914,537	39,590,402	153,505,863
Number of bidders										
1	14.60	13.27	199,561	32,736	−53,397	411.00	74.21	469,522	7,981,616	29,739,722
2	14.40	12.55	233,598	3,067	−108,816	245.00	64.08	955,109	10,633,601	43,581,689
3 or 4	14.41	11.79	286,597	−78,060	−254,803	254.00	53.15	2,421,608	21,408,072	82,417,224
5 or more	11.99	9.32	−225,862	−732,747	−946,479	313.00	49.84	5,377,590	29,071,163	124,061,570
Bonus bid class										
$250,000 or less	14.34	12.91	146,057	13,942	−50,320	354.00	81.36	126,450	4,996,521	26,168,492
$250,001–$1,000,000	13.12	11.82	135,235	−35,715	−120,061	367.00	64.58	524,998	9,660,978	37,320,012
$1,000,001–$3,250,000	13.87	11.95	341,028	−68,953	−276,345	285.00	48.77	1,874,621	20,807,215	77,006,873
More than $3,250,000	12.52	9.41	−263,487	−954,594	−1,239,353	217.00	41.01	9,002,511	42,295,839	174,003,394

[a] Where firms bid jointly, the bid shares have been attributed to each partner firm.

[b] The internal rate of return estimates reported here are not identical to those reported in Mead and Sorensen (1980) and Mead, Sorensen, Moseidjord, and Muraoka (1980) because of changes in algorithms and input data, most importantly higher forecasted oil prices and the calculation of IRRs based on the equity portion of investments in OCS leases rather than total invested capital.

12. State income taxes (subject to the unitary tax formula)
13. State severance taxes[6]

A detailed explanation of the tax analysis is available elsewhere (Mead, Sorensen, et al., 1980, Appendix I; Mead, Muraoka, and Sorensen, 1982).

Lease Profitability in the Aggregate

Table 1 provides data on rates of return for various aggregations of leases together with other information. We find that, on a before-tax basis, lessees earned a rate of return on equity of 13.16 percent on all 1,223 leases. The effect of a mixture of tax advantages enjoyed by the oil industry in the early period of our analysis, and the windfall profits tax effective in 1980 and beyond, reduced the after-tax rate of return by 18 percent below the before-tax rate (to 10.74 percent).

In addition to the IRR analysis, we have also computed the average present value per lease for various aggregations of leases. Table 1 shows that for all 1,223 leases, firms suffered an average present value loss of $192,128 per lease using a 12.5-percent discount rate.[7]

In comparing this rate of return to that of U.S. manufacturing in general,[8] it should be noted that investments in oil and gas lease development involve a higher-than-normal risk. Table 2 shows that 62 percent of all leases in our data base were dry. Consequently, the lessees had no revenues whatsoever to offset their bonus and rent payments, or their exploration and drilling costs.[9] Another 16 percent of the leases were unprofitable (on an after-tax basis) although some production occurred.[10] Only 22 percent of the leases were profitable, and these leases earned only 18.74 percent in aggregate on the after-tax basis.

Given the relatively high risk associated with investments in oil and gas leases, one would expect to find that risk-averse bidders would require a premium return relative to the average return on equity for U.S. manufac-

6. State severance taxes are not applicable to OCS leases because they are outside state jurisdiction.

7. We have provided present-value estimates using three alternative discount rates—10.0, 12.5, and 15.0 percent. Since all our costs and selling prices are in nominal dollars and our capital structure assumes some debt financing, we believe 12.5 percent is the appropriate discount rate.

8. One slight fault of our measure is that it includes the effect of returns to oil companies from OCS oil and gas leases. We have not compared the return on OCS leases with the return on oil company operations since the slight duplication in the comparisons would then become a major problem.

9. Bonus payments alone for dry leases amounted to $1.2 billion.

10. Costs, including payments to the government, exceeded revenues at a zero discount rate.

Table 2. The Record of Profitable, Productive but Unprofitable, and Dry Leases.

	Number	*Percent*	*IRR After Taxes*
All leases	1,223	100.0	10.74%
Profitable leases[a]	267	21.8	18.74%
Productive but unprofitable	199	16.3	negative
Dry leases	757	61.9	negative

[a] Profitable leases are loosely defined as those having revenue greater than cost (positive present value at a zero discount rate).

turing corporations. Table 3 shows the opposite result. On a before-tax basis, the IRR estimate for oil and gas leases is substantially below the average return on equity for all U.S. manufacturing corporations over a similar time period. Because the oil industry enjoyed net tax advantages over this time period, the after-tax rate of return for oil and gas leases was closer to the average after-tax return for all U.S. manufacturing industries. These lower-than-expected after-tax rates of return earned by lessees imply that they have historically received no risk premium and may have paid too much for the right to explore for and produce oil and gas on federal offshore lands.[11] We find no support for the allegation that the government received less than the full economic rent yielded by oil and gas leases sold under the cash bonus bidding system.

Table 3. Comparison of Rates of Return on Equity Investments in Oil and Gas Leases and All U.S. Manufacturing Corporations

	1,223 Oil & Gas Leases (IRR)	*Average Rate of Return on Equity Capital, All Mfg. Corporations, 1954–1980*[a]
Before-tax return	13.16%	20.2%
After-tax return	10.74%	11.8%[b]

[a] *Source:* Federal Trade Commission, *Quarterly Financial Reports of Manufacturing Corporations*, various issues. Our IRR estimates differ from the average rate of return to equity in manufacturing in the way they are computed and the purposes for which they are used. We have chosen to compare these two magnitudes because the rate of return to equity in manufacturing industries is, in our judgment, the best time series available to indicate rate-of-return levels for equity investments in a general sense. Note that our IRR estimate is relevant for the equity portion of investments in OCS leases only, and does not reflect the return to total capital invested in the OCS.

[b] The standard deviation by year is 2.1 percentage points with values ranging from 8.6 percent in 1958 to 16.5 percent in 1979.

11. A test of significance of a difference in mean values is not possible in our analysis. This follows from the fact that limitations of the data require that we aggregate all leases in the sample or subsets thereof in order to compute IRRs.

These results appear surprising in view of the fact that nominal crude oil prices increased sharply and unexpectedly from $3.18/bbl (wellhead) in 1970, to about $35/bbl (before windfall profits taxes) in 1981. From 1954 to 1970, however, nominal prices increased modestly (1954 = $2.78/bbl), and actually declined in real terms. This decline in real prices through 1970 may also have been unexpected. The early years are weighted heavily in a cash-flow analysis and at least partially offset the large price increases after 1970.

Crude oil and natural gas prices for the years beyond 1981 are subject to a high degree of uncertainty. For this reason we have prepared a sensitivity analysis on the after-tax IRRs based on future price scenarios 30 percent below and 30 percent above our standard scenario. Table 4 shows that even for these large variations in future prices, the effects on the estimated IRR are not large. This is due to (1) the discounting process, (2) the expected decline in production over time (at a 15-percent exponential rate), and (3) the fact that only 357 leases (or 29.2 percent of the total number of leases in the sample) were producing beyond 1979. Table 4 also shows the sensitivity of the IRR to alternative production decline rates. The standard decline rate was chosen on the basis of the actual decline rate for a sample of leases issued early in the leasing period. Again, the range of IRR estimates is not large.

Trends in Rates of Return over Time

The IRR record by lease sale is shown in Table 5 for wildcat and drainage lease sales separately. The low and negative rates of return for the initial

Table 4. Sensitivity of After-Tax Internal Rate of Return Estimates to Alternative Price Scenarios and Production Decline Rates

		Estimated IRR (after Tax)
Alternative price scenarios (both oil and gas)		
30% below standard scenario		9.74%
15% below standard scenario		10.27
Standard scenario		10.74
15% above standard scenario		11.16
30% above standard scenario		11.54
Alternative production decline rates		
Exponential	*Percentage Equivalent*	
0.10	9.05	12.20%
0.15 (standard)	13.93	10.74
0.20	18.13	9.65

Table 5. Internal Rate of Return by Lease Sale

Lease Sale Date	Number of Leases Issued		After Tax IRR (Percent)	
	Wildcat	Drainage	Wildcat	Drainage
10/13/54	90		7.73	
11/9/54	19		negative	
7/12/55	121		8.09	
5/26/59	23		negative	
8/11/59		19		7.38
2/24/60	147		13.98	
3/13/62	206		13.66	
3/16/62	205		11.01	
10/9/62		9		12.37
4/28/64		23		19.04
3/29/66		17		19.68
10/18/66	12	12	negative	14.16
6/13/67	158		9.77	
5/21/68	110		negative	
11/19/68	1	15	negative	16.54
1/14/69	10	10	7.65	13.93
12/16/69	7	9	4.35	26.05
Total, by class	1,109	114	10.04	14.59
Total, all leases	1,223		10.74	

five lease sales (from 10/13/54 through 8/11/59) appear to reflect excessive enthusiasm for the amount of oil likely to be found. The enthusiasm may have been the result of highly profitable offshore leases sold by the state of Louisiana from 1945 to 1948. We have explored this hypothesis by analyzing the profitability of these 271 Louisiana "Section 6 leases".[12] We found that, on a before-tax basis, the IRR generated by the Section 6 leases was 18.98 percent. Available data do not permit us to calculate after-tax rates of return for the Section 6 leases, but we believe that these returns were viewed to be attractive from an oil industry perspective.[13] Bidders for the 1954–1959 leases might reasonably have expected to obtain similar results from their OCS leases, but their expectations were not fulfilled.

Do Large Oil Companies Have Monopsony Power in the Oil and Gas Lease Market?

There appears to be a widespread belief, particularly in the nation's capital, that larger firms have a bidding advantage relative to smaller firms

12. For a full analysis of this record, see Mead and Sorensen (1980, pp. 48–58).

13. Tax advantages accorded to oil and gas revenues were more favorable in these early years. The tax burden on the leases issued in 1945–1948 was therefore even less than noted above for the 1,223 OCS leases in our study.

under the cash bonus bidding system. We have investigated this hypothesis and found it to be false.

The 20 largest U.S. oil companies were ranked on the basis of their worldwide sales in 1969 as follows:

1. Exxon
2. Mobil
3. Texaco
4. Gulf
5. Standard Oil of California
6. Shell
7. Standard Oil of Indiana
8. Arco
9. Tenneco
10. Continental
11. Phillips
12. Occidental
13. Sun
14. Union
15. Cities Service
16. Signal
17. Standard Oil of Ohio
18. Ashland
19. Getty
20. Marathon

On the basis of this ranking, we find that the "Big 8" firms bought 59 percent of all leases and earned the lowest after-tax rate of return (10.37 percent) compared to 11.26 percent and 11.15 percent for the "Big 9–20" and all other firms, respectively. Similarly, on a present-value basis the results are less favorable to Big 8 firms than to the Big 9–20 or to all others, regardless of the discount rate used. Using a 12.5-percent discount rate for after-tax income, the Big 8 firms suffered a present-value loss of $221,873 per lease, well above the average losses of either the Big 9–20 ($150,770) or all other firms ($145,763).

Relative to the average for all lessees, the smallest firms paid lower bonuses for their leases ($1,740,377 versus $2,228,332 average per lease). But the leases won by these smaller firms were of higher quality; the percent that were dry leases was lower (57.90 versus 61.57 percent) and the undiscounted average gross value of production through 2010 was higher ($76,615,301 versus $67,592,630).[14] These results are inconsistent with the big-firm monopsony hypothesis and suggest instead that small firms are more effective than their larger competitors in bidding for oil and gas leases.[15]

Does Joint Bidding Reflect Anticompetitive Behavior?

Concern has been expressed by both academic and government experts that the practice of joint bidding might reduce competition and yield

14. The fact that the actual gross value of production through 1979 for the smallest firms is less than that of all lessees ($15,830,720 versus $16,698,774) reflects our earlier findings that small firms were relatively slow in drilling wells and in producing oil from such leases. Consequently, they benefited more than larger firms from the rapid product price increases in the 1970s, and forecasted for the future (Mead and Sorensen, 1980, pp. 85–115).

monopsonistic returns or, alternatively stated, that the government might fail to collect the full economic rent from OCS leases (Gaskins and Vann, 1979, pp. 210–220). The fear of anticompetitive results from joint bidding led the Department of Interior to issue a regulation on October 1, 1975, banning joint bidding among firms that individually produce more than 1.6 million barrels of oil and natural gas equivalent per day. This ban was formalized in legislation as the Energy Policy and Conservation Act (P.L. 94–163, December 1975).

Our findings, as shown in Table 1, indicate that leases sold to joint bidders yield higher internal rates of return both before and after taxes and that the net present value loss by joint bidders is less than that of solo bidders (12.5-percent discount rate). The higher internal rates of return on joint leases are achieved even though the average bonus bid is 70 percent above that of solo bid leases. But leases obtained by joint bidders are of much higher quality. This conclusion is supported by the fact that through the year 1979 the average gross value of production for joint bid leases was 49 percent higher than that for solo bid leases, and leases won by joint bidders showed a lower percent dry relative to solo bid leases. The data suggest that the joint-bidding device is used by firms to spread the risk associated with higher bonus bids for better-quality tracts, and to facilitate entry, especially by smaller firms.[16]

Joint bidding appears to advance the interests of small relative to large firms. Table 6 shows that "all other lessees" experienced a 13.34-percent IRR on their joint bid leases, compared to 9.54 percent on their solo leases. This 40-percent increase is unmatched by either the Big 8 (10 percent) or the Big 9–20 (11 percent) firms. Also, the small-firm IRR on joint leases was higher than that of either larger-firm size class. Using a 12.5-percent discount rate, the small firms realized an average net present value of $138,208 per lease on their joint bid leases, whereas larger firms had a net present-value loss on both joint and solo bid leases. Discounting at 12.5 percent, the only profitable class shown in Table 6 was joint bid leases won by "all other lessees." Further, through joint bidding, small firms bid for more expensive leases that turned out to be of much higher quality, whether measured by percent dry or by the average gross value of production per lease through 1979. Conversely, Big 8 firms bid substantially more for their solo bid leases than did their smaller competitors. This finding is consistent with findings reported by Millsaps and Ott (1981) based on 10 lease sales in 1972–1975. Finally, the Big 8 firms made less use of the joint-

16. We have conducted a regression analysis of bidding that shows interaction between variables reflecting (1) firm size of the winning bidder, (2) whether the winner bid jointly or solo, and (3) whether the lease was classified as wildcat or drainage. That analysis found that higher joint bids relative to solo were confined to drainage tracts where the winning bidder

Table 6. Solo- and Joint-Bidding Results by Firm Size Class, 1,233 OCS Oil and Gas Leases

	Big 8 Firms	*Big 9–20 Firms*	*All Other Firms*
Total number of leases	725	299	199
Solo bids			
IRR after taxes	10.07%	10.63%	9.54%
Present value (12.5%)	−$235,479	−$186,766	−$249,005
Number of leases	550	165	146
Percent dry	62.18%	67.88%	61.64%
Average bonus	$2,137,289	$1,682,357	$946,115
Average gross value of production through 1979	$16,348,124	$12,965,127	$9,749,654
Joint bids			
IRR after taxes	11.09%	11.77%	13.34%
Present value (12.5%)	−$179,201	−$106,308	$138,208
Number of leases	175	134	53
Percent of total	24%	45%	27%
Percent dry	60.18%	58.55%	47.59%
Average bonus	$2,853,787	$3,183,843	$3,925,046
Average gross value of production through 1979	$17,878,283	$22,500,186	$32,557,087

bidding procedure than either the Big 9–20 or all other lessees. Big 8 firms acquired 24 percent of their total leases through joint bidding, compared to 45 percent for the Big 9–20 and 27 percent for the smallest firms.

The after-tax rate of return earned on joint bid leases (11.74 percent) is about the same as that for all manufacturing (11.78 percent). These results do not support the hypothesis that joint bidders earn excessive returns on their OCS investments relative to returns in manufacturing, disregarding any risk differential. Our findings do not indicate anticompetitive consequences of joint bidding.

Returns on Wildcat Versus Drainage Leases

Wildcat leases are defined as tracts for which there are no drilling data available that would indicate potential productivity. When a reservoir has been located that is expected to extend into adjacent unleased acreage, the adjacent tract is offered for sale as a "drainage" tract. Since less information is available regarding the production potential of wildcat tracts, one would expect lessees to require a higher rate of return to compensate them for the higher dry-hole risk on wildcat tracts.

Our findings show contrary results. The 10.04-percent after-tax return on wildcat leases is substantially less than the 14.59-percent IRR earned on drainage tracts. Whereas the average present-value *loss* for wildcat tracts

amounted to $249,045 per tract, drainage leases showed a present-value *gain* of $361,594 per tract (12.5-percent discount rate). Further, the higher risk associated with wildcat leases is reflected in the negative returns for five of the 13 lease sales shown in Table 5.

The average price paid for drainage tracts, $4.9 million, is much larger than the $2.0 million paid for wildcat leases. The higher quality of the drainage tracts is explained by the fact that the value of oil and gas production through 1979 from the average drainage tract was $39,590,402, or 2.8 times the $14,345,622 produced from wildcat tracts.

The apparent inconsistency between the hypothesis based on finance theory and the internal rate-of-return findings is explained by asymmetrical information (Mead, Moseidjord, and Sorensen, 1982). When oil is discovered on an OCS tract, information is generated by drilling, which locates a reservoir expected to extend into adjacent nonleased tracts. This information is considered proprietary and available only to the lessee. When the adjacent drainage tract is offered for lease, one bidder (possibly including partners in a joint bid) has superior information, which apparently leads to superior bidding results. The lessee of a wildcat tract is therefore buying two assets: (1) the right to produce any oil or gas found on the tract, and (2) geological and reservoir information that can be of value in subsequent drainage lease sales of neighbor tracts. The apparently low IRR earned on wildcat leases is to some degree explained by the fact that the value of information gained in exploratory drilling of wildcat tracts is not included in the calculated flow of income attributed to such tracts. Conversely, the rate of return on drainage tracts includes the value of information obtained from wildcat tracts.

Does Increased Bidder Participation Lead to Higher Bonus Bids and Lower Returns?

Competitive economic theory would lead one to expect that bidding intensity would increase with the number of bidders and that, as a consequence, profitability would decline. This hypothesis is confirmed by the results shown in Table 1. The after-tax IRR declined steadily from 13.27 percent in the case of one-bidder leases to 9.32 percent where five or more bidders were in competition. From the lessee's perspective, present value (using a 12.5-percent discount rate) declines as bidders increase in number and becomes deeply negative for situations of intense competition. From the government's perspective, economic rent was not fully collected on one- and two-bidder leases, but was more than fully collected in the case of three-or-more-bidder leases. The average number of bidders for all tracts was 3.33. The average bonus increased sharply from $469,522 per tract in

the case of one-bidder leases, to $5,377,590 per tract where five or more bidders were present.

Increasing numbers of bidders per tract reflect not ony increased competition but also increased quality of tracts, both anticipated and actual (in the aggregate). The average gross value of production through the year 1979 rose dramatically from $7,981,616 per tract for one-bidder leases, to $29,071,163 for leases with five or more bidders.

Does Bidding Appear to Be Rational?

Our findings lend support to the argument that bonus bidding for oil and gas leases is rational. Measuring lease quality by either ex-post data on percent dry holes or the actual average gross value of production through 1979, we find an apparent close correlation between the value of production and the value of bonus bids.[17] However, the results also indicate that bonus bids outpace quality, with the result that after-tax rates of return decline from 12.91 percent for bonus bids equal to or less than $250,000, to 9.41 percent for bonus bids in excess of $3,250,000.

CONCLUSIONS

Our analysis of 1,223 oil and gas leases issued from 1954 through 1969 reveals that lessees earned a 10.74-percent rate of return on equity on their lease investments, after taxes. This rate of return appears to be approximately equal to or somewhat below the average after-tax rate of return on equity for all U.S. manufacturing corporations over the years 1954–1980 (11.8 percent) and indicates an effectively competitive lease sale market. Using a 12.5-percent nominal discount rate, we determined that lessees suffered an average $192,128 loss of present value per lease. Thus, in the aggregate, the government collected at least the full economic rent available under the conventional bonus bidding–fixed royalty system.

The Big 8 firms in the oil industry earned a 10.37-percent after-tax return on their 725 leases, and suffered a loss in present value amounting to $221,873 per lease, using a 12.5-percent discount rate. All other firms earned higher returns and had lower present-value losses. Thus, the data do not support the charge that large firms have bidding advantages under the cash bonus bidding system.

The record shows that firms bidding jointly pay more for their leases, obtain higher quality leases, and earn higher rates of return, relative to solo-bidding firms. The 11.74-percent return earned by joint-bidding firms

17. This conclusion is confirmed by multiple regression analysis. See Jones, Mead, and Sorensen (1980, pp. 321–324).

closely approximates the after-tax rate of return on equity recorded for all U.S. manufacturing firms in the same period. The results do not support the hypothesis that joint bidders pay less for their leases or earn excessive returns on their OCS investments relative to returns in manufacturing. Compared to the Big 20 firms, smaller firms make relatively more use of the joint-bidding procedure and in the process pay higher bonuses, win higher-quality leases, and achieve higher net present-value performance.

Our findings confirm earlier results indicating that as the number of bidders competing for tracts increases, so does the amount of the high bid. The number of bidders is a proxy for both the extent of competition and the quality of the tract. Since the rate of return declines as the number of bidders increases, the force of additional competition tends to outweigh the quality factor.

We conclude that bonus bidding tends to produce rational results. Higher bonus bids are correlated with both fewer dry holes and higher gross value of production per lease.

Finally, given the fact that wildcat leases involve higher risk relative to drainage leases, it would be expected that their rate of return would also be higher. Our findings are to the contrary. Wildcat leases yielded a 10.04-percent after-tax return while drainage leases yielded 14.59 percent. The apparent explanation for this contrary result is that drainage leases are generally won by firms owning adjacent leases and such firms have superior information concerning the extent of the oil and gas reserves available on the drainage tracts. This asymmetrical information leads to superior performance in terms of returns on investments. The low return earned on wildcat leases is to some degree explained by the fact that the value of information gained in exploratory drilling is not included in the flow of income attributed to such tracts.

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